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Asian Development Bank



FINAL REPORT

BANGLADESH

THIRD CAPITAL MARKET DEVELOPMENT PROGRAM (CMDP III)
(TA-8512 BAN)

PRESENTED TO
ASIAN DEVELOPMENT BANK

SUBMITTED BY
THE ARIES GROUP, LTD.
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BANGLADESH
TA-8512: THIRD CAPITAL MARKET DEVELOPMENT PROGRAM (CMDP III)

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Table of Contents

	<u>Page No.</u>
1 Executive Summary	1
1.1 Capital Markets – A Potential Engine for Economic Development	1
1.2 The Stock Market Crisis – Recovering from a Severe Blow	1
1.3 CMDP II – Starting on the Path to Recovery.....	1
1.4 The Challenges Lying Ahead	2
1.5 CMDP III – Mapping the Road Ahead.....	2
2 Issues and Challenges.....	3
2.1 Legal Regulatory & Policy Issues.....	3
2.1.1 Enhancing BSEC's Effectiveness.....	3
2.1.2 Strengthening the Intermediaries – <i>the 3-Legged Stool Approach</i>	5
2.1.3 Operationalizing the Special Capital Market Tribunal.....	8
2.1.4 Operationalizing the Financial Reporting Council.....	9
2.1.5 Other Rules and Regulations	9
2.2 The Mutual Fund Industry – Measures to Encourage Growth.....	10
2.2.1 Related Party Transactions.....	11
2.2.2 A Broadly Representative Industry Association	11
2.2.3 Repurchase Program for Closed-end Mutual Funds	12
2.2.4 Uniform Performance Measurement	12
2.2.5 Exchange Traded and Money Market Funds.....	13
2.2.6 Leveling the Playing Field.....	14
2.2.7 Enhanced Unitholder Protections.....	14
2.3 Bond Market Development	14
2.3.1 Issuance Strategies to Deepen Benchmarks.....	16
2.3.2 Issuance of Floating Rate Notes	16
2.3.3 Syndicating Long Dated Issues.....	16
2.3.4 Evolution of the Primary Dealer System – <i>A Segmented Approach</i>	17
2.3.5 Rules to Allow for Short Selling, Borrowing & Lending	17

2.3.6	Fiscal Incentives to Catalyze the Growth of Bond Mutual Funds	17
2.3.7	Funding Options for Public and Private Pension Systems	17
2.3.8	Encouraging Broader Retail Distribution of Government Securities	18
2.4	Developing the Insurance Industry	18
2.4.1	Enhancing IDRA's Operational Effectiveness	18
2.4.2	Other Legislative Action Required	19
2.4.3	Adoption of Pending Rules/Regulations	19
2.4.4	Recapitalizing & Commercializing the State-Owned Insurers.....	20
2.4.5	Recapitalizing the Private Insurance Sector	20
2.4.6	Acquisition of a Regulatory Information & Data Exchange Facility	20
2.4.7	Other Areas	21
2.5	Pension Reforms	21
2.6	Private Equity and Venture Capital.....	22
2.6.1	Opportunities for Enhancing the Enabling Environment	23
2.7	Derivatives	25
2.7.1	Demand Study	26
2.7.2	Policy Framework.....	26
2.7.3	Strategic Plans.....	26
2.7.4	Developing Supportive Financial Market Infrastructure	26
2.8	Central Clearing	27
2.8.1	Short Term Initiatives (next 4-6 months)	28
2.8.2	Medium Term Initiatives (next 12-18 months)	28
2.9	Developing the Market for Sukuk	28
2.9.1	Legal Regulatory and Policy Framework – Developing an Enabling Environment.....	29
2.9.2	Promotion and Marketability of Sukuk	30

Appendices

Appendix 1: Legal, Regulatory & Policy Issues	Appendix 7: Derivatives & FMI
Appendix 2: Mutual Funds	Appendix 8: Developing Enhanced Clearing
Appendix 3: Bond Market Development	Appendix 9: Promotion of Sukuk
Appendix 4: The Insurance Industry	Appendix 10: Integrating ICT
Appendix 5: Pension & Provident Funds	Appendix 11: Key Persons Met/Interviewed
Appendix 6: Private Equity & Venture Capital	Appendix 12: IAAG Comments/Feedback on DFR

Acknowledgements

We would like to take this opportunity to thank the members of the Interagency Advisory Group (IAAG) for the useful feedback provided to earlier versions of our reports as well as all of the stakeholders with whom we have met over the course of this assignment - a partial list of which is attached as *Appendix 11* – for giving generously of their time - often on very short notice - to meet with us, and for patiently and thoughtfully responding to our many detailed inquiries. These interactions have been invaluable to us in developing a better understanding of the issues and challenges faced by a wide range of stakeholders on a wide range of topics. We hope we have accurately reflected these issues and concerns in this report.

The Aries Group has had the privilege of being involved in advising the Asian Development Bank and the Government of Bangladesh on financial sector development issues since the early 1990's, and is honored to have contributed to each of the past three ADB-supported capital market development programs (CMDP, CMDP II and CMDP III). We are grateful to have been entrusted with this assignment to assist in designing the Third Capital Market Development Program (CMDP III), and hope, through our work, we can contribute to the realization of the significant potential inherent in Bangladesh's capital markets.

While acknowledging the contributions of the IAAG and all of the persons with whom we have met, we take full responsibility for any errors and/or omissions and welcome any feedback that would serve to improve the quality of the outputs of this assignment.

Preface

In our Interim Report, we focused on key suggestions that could be developed into “high-value” recommendations - namely those that have the potential, given implementation, of making a significant positive impact on the development of Bangladesh’s capital markets (i.e. potential “catalysts”).

We received valuable feedback from the Inter Agency Advisory Group (IAAG) and the Asian Development Bank (ADB) on these suggestions, which we have carefully studied and dully considered in arriving at the recommendations in this Final Report.

In our Draft Final Report we made a wide range of recommendations across the ten targeted areas of focus, namely:

- Legal, regulatory, and policy frameworks;
- Further development of the mutual fund industry;
- Bond market development;
- Developing the insurance industry;
- Pension reforms;
- Developing sources of “risk capital” (venture capital and private equity);
- Derivatives and derivatives markets;
- Central clearing;
- The development of Sukuk; and
- Integrating information and communications technology (ICT) at BSEC

We received valuable comments/feedback from the IAAG and ADB on our Draft Final Report which have been incorporate/included in this Final Report as indicated in Appendix 12 (with respect to IAAG feedback/comments).

The first section of this report summarizes and provides an overview of our key suggestions/recommendations in each of the above ten areas of focus and is targeted to the non-specialized reader providing an executive-level overview of all of our key suggestions & recommendations. This overview/summary is followed by ten separate appendices each containing our detailed findings and analyses in each of the ten areas of focus mentioned above. These individual appendices are targeted to the specialized reader seeking a more detailed treatment of each of the ten areas of focus. We have structured the report in this manner so as to facilitate the IAAG’s task of reviewing it - i.e. so that each member of the IAAG may focus on material that is within their area of interest and not be burdened with reading extraneous material.

1 Executive Summary

1.1 Capital Markets – A Potential Engine for Economic Development

To improve infrastructure and raise growth rates, Bangladesh must ramp up both public and private investment rates. At almost 30 percent of GDP, Bangladesh has an enviable savings rate, but more effective means of channeling domestic savings into infrastructure investment will need to be found. At present, however, Bangladesh's capital markets may not be able to fulfill these financing requirements. A well regulated, competitive environment is critical to realizing deeper and broader capital markets with diversified products that can rise to the challenge that Bangladesh's capital markets will face over the next decade and beyond.

1.2 The Stock Market Crisis – Recovering from a Severe Blow

The stock market crisis of 2010/11 was a significant setback to the development of Bangladesh's capital markets. Following the considerable losses suffered by many retail and institutional investors, a government-commissioned Probe Report found misconduct in the capital markets that led to a general loss of public confidence in the effective functioning of the market.

1.3 CMDP II – Starting on the Path to Recovery

A number of critical initiatives were adopted under CMDP II that, in due course, and given appropriate follow-through, promise to put Bangladesh's capital markets on a path to controlled, sustainable long-term development. One of the essential objectives of CMDP II was to begin the painstaking process of restoring public confidence through a series of initiatives designed to address fundamental structural weaknesses in the capital markets' legal, regulatory, policy and institutional frameworks. Ninety-nine initiatives were proposed under CMDP II, all of which have been adopted in one form or another. Twenty-eight of these initiatives were ultimately adopted as Policy Actions under the CMDP II Policy Loan.

One of the major achievements of CMDP II was the adoption by BSEC of the *Capital Market Development Master Plan* (CMDMP) in October 2012 which lays out a sequenced and prioritized action plan for the development of Bangladesh's capital markets through 2022.

Another key achievement supported by CMDP II was the adoption by the government of a *National Insurance Sector Development Policy* (NISDP) in July, 2014. This policy document serves as a guiding framework under which the insurance industry, in cooperation and partnership with the government, can develop a strong and robust insurance sector. It spells out a 3-phased approach to the development of Bangladesh's insurance industry. While steps have already been taken to implement

some of the early measures called for in the NISDP, much of the difficult work remains to be done in the years ahead.

1.4 The Challenges Lying Ahead

Despite the remarkable progress made under CMDP II, there remain considerable challenges to the long-term sustainable development of Bangladesh's capital markets.

- Our stakeholder consultations revealed that the poor quality of financial information remains a major/key impediment despite the concerted efforts of a wide range of stakeholders to make improvements;
- Although facing better prospects in the future, the capacity of the regulatory authorities remains constrained;
- Capital market intermediaries and insurance companies face significant challenges, both in terms of financial health and technical knowledge/capacity;
- Distortions (e.g. those stemming from the NSS program) continue to challenge and constrain the development of deep and liquid markets for government securities and thus the emergence of a credible yield curve based upon which an active and resilient corporate fixed income market might emerge.

1.5 CMDP III – Mapping the Road Ahead

CMDP II has been regarded as largely successful in beginning the process of repairing the damage sustained as a result of the stock market crisis of 2010/11. The ADB and GOB are now exploring a third capital market development program (CMDP III). The next series of reforms (to be adopted under CMDP III) are expected to consolidate advances and build on the momentum developed under CMDP II; and support initiatives having the potential for the greatest impact on the development of capital markets in select key areas.

As envisioned in both the CMDMP and the NISDP, there is a significant need for *strengthening and consolidation* of market participants. We would envision this happening in **three ways**:

First, authorization ("admission") standards will need to be raised and better enforced;

Second, having raised the standards for entry, regulators will need to strengthen conduct standards where necessary, and be vigilant in enforcing these standards;

Third, undercapitalized and poorly resourced participants will need to be identified and dealt with, otherwise the advances made in the first two areas will be fleeting and unsustainable.

2 Issues and Challenges

In this section we present an overview/summary of the *key issues* and challenges, identified through our consultations with a wide range of stakeholders, and suggestions/recommendations for addressing them. A more complete analysis of all of the issues and challenges and related recommendations can be found in Appendices 1-10 of this report. This section is divided into ten sub-sections, each addressing one of the broad targeted areas of focus for CMDP III ("targeted areas") mentioned earlier.

2.1 Legal Regulatory & Policy Issues

As in CMDP II, the legal, regulatory and policy frameworks feature prominently in the list of issues and challenges facing the capital markets. Through measures it has adopted since 2011, BSEC is playing a key role in the effort to restore confidence in Bangladesh's capital markets. The many measures it has already taken, and those to which it has committed through the adoption of its CMDMP, if consistently pursued, are expected to, in due course, produce positive results. Furthermore, the demutualization of the stock exchanges has resulted in significant governance reforms designed to enhance investor protections and help to assure the integrity of the markets.

BSEC has stepped up its enforcement actions in the last year and a number of prominent cases have been brought by it over this period that have received wide coverage and attention in the media. These actions are important, not only because they signify that BSEC is actively pursuing those engaged in misconduct, but also because the publicity surrounding these cases communicates the message that the "new" BSEC is serious about prosecuting violators of the securities laws and regulations, and will vigorously pursue them.

2.1.1 Enhancing BSEC's Effectiveness

While BSEC has made considerable progress in strengthening the legal, regulatory and policy frameworks in the last two years, its effectiveness remains challenged. A number of key initiatives we have considered in this regard have the potential for transforming the organization into a considerably more effective regulator. These include:

2.1.1.1 Strategic Planning Initiative

It is suggested that BSEC develop and adopt a strategic planning process and dedicate adequate resources to strategic planning. The strategic planning process adopted by Bangladesh Bank under a World Bank central bank strengthening project may be referenced as a possible model. Strategic planning would enable BSEC to more effectively oversee the expanding capital markets and the complexities that this will bring. It would allow the organization to become more forward-looking, thus enabling it to identify emerging opportunities and issues of concern and to develop proactive plans to address these.

2.1.1.2 Information and Communications Technology (ICT) Initiative

Anecdotal evidence (and our own experience in other jurisdictions) indicates that regulatory authorities that have embraced modern technologies and incorporated them into their daily processes and procedures have consistently improved organizational effectiveness in due course. BSEC's use of ICT is presently not at an expected level. BSEC is yet to utilize the fundamental information and communications technologies and systems that are commonly utilized by the private sector (including entities BSEC oversees).¹

As a critical first step in increasing the use of ICT throughout the organization, it is suggested that BSEC develop a comprehensive and well-coordinated plan for the integration of ICT into its operations to facilitate its daily activities and improve its operational effectiveness, and that it dedicate adequate resources to this important area.

We have undertaken an assessment of BSEC's systems requirements and have chalked out the contours of a "suite" of mission-critical information and communications systems that would address these needs in Appendix 10. The systems we propose are designed to support BSEC's eventual transition to a risk-based approach to supervision (RBS), and to facilitate the timeliness and accuracy of regulatory filings made by the industry that would enable the close and regular monitoring of high-risk entities,

2.1.1.3 Delegated Procurement Authority

Unlike some other segments of the financial sector, capital markets can be highly dynamic – competitive and innovative.² In this environment, the securities regulator must be able to stay "ahead of the curve" by regularly scanning the horizon to spot emerging trends, new products/services; assessing the risks inherent in these products/services; developing and executing plans to address them from both regulatory and market development perspectives. To be responsive, BSEC must be able to quickly put in place regulatory frameworks that include risk monitoring and assessment mechanisms. In so doing, BSEC may need to procure/engage specialized (human and technology) resources quickly in response to emerging issues of concern. The need for such responsiveness will become more pronounced as BSEC continues to execute its CMDMP. It is our understanding that, at present, BSEC's procurements of goods and services are subject to the TO&E process, which we are informed can be quite lengthy, time consuming and uncertain.

¹ We have been informed that BSEC is contemplating improvements to its internal and external reporting processes through a modern online digital system

² For example, in this respect, the capital market segment is very different from the more stable and predictable banking sector, and requires its regulator to be highly responsive to market developments. Otherwise, inadequately or improperly regulated and monitored products and services could lead to a build-up in systemic risks that may go unnoticed by a non-responsive regulator.

We suggest that the government consider delegating, to BSEC, the authority to conduct procurements (in full compliance with government procurement rules and regulations) of the various goods and services that are required to fulfill its market development and supervision mandates. Our discussions with Bangladesh Bank officials suggest that the central bank is authorized to conduct its procurements on its own authority – i.e. that it is not required to pass its procurements through the TO&E process/procedure. We suggest the same treatment be provided to BSEC on the matter of procurements.

2.1.1.4 Office of Internal Control & Compliance (OICC)

As mentioned above, one of the key tasks ahead for BSEC is to restore the confidence of the investing community in the integrity of the markets. In so doing, BSEC must, itself, be beyond reproach. The present leadership of BSEC has done a remarkable job of restoring the integrity of BSEC. Looking to the future, to guard against a recurrence of the unfortunate incidents leading up to the replacement of the senior level BSEC officials in 2011, we suggest BSEC consider establishing an Office of Internal Control and Compliance (OICC) as a separate department. An assessment of scope of work of Internal Control and Compliance department may be undertaken independently.

2.1.1.5 Office of General Counsel

We concur with the views of many at BSEC and many of its external stakeholders that BSEC's long term effectiveness would be considerably enhanced by the addition of a number of well-qualified lawyers to its staff. Its ability to promote and comment on legislation that affects its responsibilities - to promulgate rules; to investigate violations of the securities laws; to build and successfully resolve enforcement cases; and to adopt and maintain international best practices - would be markedly strengthened by establishing an Office of General Counsel and staffing that office with qualified lawyers.

2.1.2 Strengthening the Intermediaries – the 3-Legged Stool Approach

Market intermediaries constitute one of the foundational “building blocks” of the capital markets. However, broker-dealers and merchant banks were dealt a hard blow as a result of the 2010/11 stock market crisis and many remain in a weakened financial state that constrains them from positively contributing to the growth and development of the capital markets. Strong capital markets cannot be (re)built on a weak intermediary industry.

The solution we have been developing in consultation with BSEC and other stakeholders has three elements, all of which will need to be implemented - more-or-less simultaneously - and none of which should be omitted. We liken it to a 3-legged stool that can stand only if all three legs are present. Thus, for ease of reference, we have labeled it the “3-Legged Stool Approach” to strengthening the intermediaries.

2.1.2.1 Financial Strengthening – The First Leg

The first element of the approach (1st leg of the stool) would include measures to strengthen the intermediaries' (i.e. broker-dealers and merchant banks) financial condition. This element would have two sub-components (measures), namely:

- The adoption of a capital adequacy standard that is more directly and closely related to the levels and types of risks being born by the intermediary (i.e. a Risk Based Capital Standard); and
- The recognition and resolution of capital deficiencies stemming from the 2010/11 stock market crisis.

The matter of unrecognized losses on margin accounts should be addressed before a risk based standard for minimum capital is adopted. Otherwise, it may not be possible to effectively enforce the risk-based capital standard.

Margin Lending-Related Losses - We are informed that one of the most significant contributors to the financial losses suffered by broker-dealers and merchant banks in the wake of the 2010/11 crisis has been those stemming from their margin lending activities. For many institutions, these losses have continued to worsen, as the affected loans ("infected portfolios") may not have been written off, and, in the meantime, accrued unpaid interest and a deteriorating market have added to the initial losses. We are advised that, in many instances, the full magnitude of these losses may not have been recognized in the intermediaries' financial statements.

BSEC's response has been to provide regulatory forbearance/relief by temporarily suspending certain provisions of the Margin Rules, 1999 for Broker-Dealers.³ While an investigation into the proximate causes of such losses is beyond the scope of this assignment, anecdotal evidence suggests that there is likely to have been more than one contributing factor, and that the mix of factors differs by institution.

Regardless of the factors contributing to these losses, the industry remains in a weakened financial state because of them. We would suggest that the situation may need to be addressed in a *more systematic and comprehensive manner* than the temporary forbearance approach presently adopted by BSEC, and it is our recommendation that these losses be dealt with in conjunction with a broader initiative to enhance the financial strength of the brokerage and merchant bank industries as a whole. The "market overhang" resulting from it is likely to continue suppressing the stock market until the situation is resolved decisively.⁴

³ We are informed, however, that BSEC has not formalized parallel forbearance for Merchant Banks. (Merchant Banker and Portfolio Manager Rules, 1996)

⁴ "Market overhang" is a phenomenon whereby investors put off buying shares of a particular stock, group of stocks, or the entire market based on a widely held belief that a large volume of sales are awaiting execution once certain conditions are met – e.g. a target price is achieved. Investors are hesitant to buy until they are reasonably certain that

Assessing the Level of Capital Impairment - As a critical first step, BSEC would need to conduct a study to determine the scope (i.e. the number of institutions affected) and magnitude (the amount per affected institution) of the losses (i.e. level of industry-wide capital impairment) associated with the events of 2010/11.

Margin Loan Loss Resolution and Capital Restoration Plan - Once the level and nature of the impairment is determined, it would be our suggestion that BSEC, in consultation and collaboration with the industry, the MOF, Bangladesh Bank, NBR, and ICAB, devise a comprehensive, mutually acceptable solution that would decisively resolve the matter in a way that would allow the industry to move forward without the “baggage” that has been weighing it down in the last 3 years.

Risk Based Capital Standard - The BSEC has been working (both on its own, and through the assistance provided under a concurrent ADB technical assistance project) to develop a capital standard that is more “risk-aware” than the current one. While the recommendation of a specific model is beyond the scope of our assignment, our suggestion is that the model adopted meet two “tests” – the first is that it can be easily understood, implemented, monitored and enforced; and the second is that it appropriately consider (and reflect) ground realities.⁵

2.1.2.2 Strengthening Business & Market Conduct Standards – The Second Leg

Business and market conduct standards are those to which all market intermediaries should be required to adhere in dealing with clients and their assets. Among other matters, they set out the responsibilities intermediaries must have toward their customers, require that intermediaries give priority to their customers’ interests over their own, and the manner in which customers’ assets should be held and protected. While BSEC regulations appear to adequately and appropriately address most of the central provisions typically found in business and market conduct regulations, many of the stakeholders we have encountered in our consultations have highlighted the inadequacies of intermediaries in this area, indicating that these inadequacies may be a result of the lack/absence of appropriate monitoring and/or enforcement measures.

We suggest that BSEC conduct a comprehensive review and assessment of its business and market conduct regulations to evaluate whether or not they are adequate and adhere to international standards of best practice. We also suggest that it review its examination protocols to ensure that business and market conduct is an important focus of these examinations. BSEC may also wish to review - and if required, revise - its policies and procedures to ensure that customer complaints receive proper attention –

the large volume of pending sales is absorbed by the market. Depending on overall market liquidity, a market overhang can last for weeks, months or even years.

⁵ In particular, that the situation in Bangladesh may favor the adoption of a liquidity-driven model over a solvency-driven one.

at the level of the intermediary, the stock exchanges, and in the context of BSEC's own handling of investor complaints.

2.1.2.3 Professional Certification – The Third Leg

To ensure a high quality of professionalism throughout the industry it is necessary for the *key personnel* of intermediaries to be certified under a program that ensures that they possess and maintain a minimum level of knowledge and skills, and be adequately informed about their duties and responsibilities to their customers.

BSEC does not currently require certification of licensed intermediaries.⁶ Another ADB TA project has developed a draft curriculum and draft rule that would require professional certification for key employees of intermediaries, which is under consideration by BSEC, and we suggest that it be adopted at the earliest.⁷ In conjunction with the rule, it will be necessary to develop standard examinations that all professionals must take and pass before being licensed. Because a blanket exemption from examinations for experienced persons would inhibit the upgrading of skills and knowledge, we would advise against such exemptions (e.g. for persons with a certain level of experience in the industry) to the certification requirement.

In order to maintain currency in their knowledge and skills, we also suggest that all certified market professionals be required to undergo a minimum number of hours (e.g. 20, or such number of hours determined by BSEC) of continuing education per year as a condition of maintaining their licenses.⁸

2.1.3 Operationalizing the Special Capital Market Tribunal

Initiative 36 of BSEC's CMDMP called for establishment of a Special Capital Market Tribunal (SCMT) to address two principal problems with the enforcement of securities laws and regulations in Bangladesh, namely that ordinary court dockets are seriously overcrowded, resulting in cases not being heard for months or even years; and the inordinate delaying tactics permitted under the Code of Criminal Procedure, 1898.⁹ An amendment to the Securities Ordinance (Section 25B) authorized the establishment of a Special Capital Market Tribunal (SCMT). The SCMT was established by Notification of the Government in January 2014, and a Sessions Judge, Hon. Humayun Kabir, was appointed to lead the SCMT.

⁶ We are advised that the BSEC provides certificates to Authorized Representatives of stock brokers/stock dealers of DSE and CSE. Before issuing such certificates, it arranges training programs for such applicants in collaboration with the DSE and CSE, but no examination is required to receive such certification.

⁷ ADB TA: *Enhancement of Governance and Capacity of the Capital Market, Component 3: Market Intermediaries*

⁸ Furthermore, the levels of activity around which the markets appear to have stabilized are likely to be sustained for the foreseeable future, and may not be sufficient enough to sustain the large number of authorized intermediaries currently comprising the industry. This process of strengthening, may serve to clarify the seriousness of intentions of current intermediaries.

⁹ CMDMP, Section 2.2.8, p.10

One of the principal impediments to the expeditious disposal of criminal cases has been the inordinate delaying tactics permitted under the Code of Criminal Procedure, 1898. If adopted and appropriately administered, effective **case management rules** would provide significant assistance in expediting the operations and effectiveness of the SCMT. Another ADB project has prepared draft case management rules for the Special Tribunal which are designed to expedite the just disposal of criminal cases.¹⁰

We would suggest that BSEC should consider the adoption and implementation of case management rules by the SCMT within one year after it is first convened and its operations commence. Such case management rules could either be those proposed by TA No 8228 BAN or workable case management rules patterned after them that capture their intent. At a minimum they should address: active case management; case progression officers; case management powers; plea and case management hearings; and conduct of a trial - its preparation, readiness and management.

2.1.4 Operationalizing the Financial Reporting Council

Our stakeholder consultations in June and July 2014 and subsequent one-on-one meetings with key stakeholders revealed that the poor quality of financial information remains a major/key impediment despite the concerted efforts of a wide range of stakeholders to address this. Initiative 37 of BSEC's CMDMP called for the adoption of a Financial Reporting Act. We understand that such an Act has been drafted and placed before parliament (the Draft Financial Reporting Act – DFRA) and that its adoption is expected imminently. The DFRA currently under consideration is intended to establish the Financial Reporting Council (FRC) to bring financial reporting of public interest entities (PIEs) under a well-regulated framework with the objectives of improving the quality of accounting and auditing services; enhancing the credibility of auditing reports, and; improving the capacity of the accounting and auditing profession.

Once the DFRA is adopted the FRC would need to take a number of organizational initiatives in its first year of operation to prepare it to fulfill its responsibilities. In Appendix 1 of this report we provide detailed suggestions on operationalizing the FRC. In summary, first and most basic are initiatives that would ensure that the FRC is solidly established, engages the best and most talented leadership and has well thought out, workable strategic and business plans. FRC will also need to adopt standards of accounting and auditing, ensure accountants and auditors comply with these standards, and carry out other relevant functions.

2.1.5 Other Rules and Regulations

The need for a number of rules and regulations has come to our attention during our stakeholders' consultations, and as a result of our own assessments. Two areas stand out as crucial in this respect.

¹⁰ ADB TA-8228 BAN: *Enhancing Efficiency of the Capital Market*

2.1.5.1 Corporate Takeover Regulation

In addition to the many other benefits of a well-functioning market for corporate control, it can also serve as a disciplinary mechanism that induces managers to manage firms more efficiently. Successful takeovers can potentially move assets to higher-valued uses or into the hands of more effective management. Since market prices may not adequately reflect the long term value of a firm, takeovers at “fair value” may increase value to shareholders. Thus, the mere threat of a takeover can prevent wasteful investment of company assets in unprofitable pursuits.

We have been advised by BSEC officials that the takeover rule, (Acquisition of Substantial Share, Takeover and Control Rules, 2002) is not currently being enforced due to its manifold deficiencies. Considering that the present takeover rule is generally considered to be inadequate, we suggest that it be rewritten incorporating principles that are consistent with best international and regional practices.

2.1.5.2 A Regulation for Rulemaking

Bangladesh’s capital markets are transitioning through a period of development and reform. As the newly appointed boards of directors of the recently demutualized exchanges gradually gain their footing, as market infrastructure is strengthened and new products are developed and offered, the need for coordination and transparency in the rulemaking process becomes more pronounced. To bolster BSEC’s rule-making process, we suggest that it consider adopting a rule-making process -ideally in the form of a rule/regulation. In Appendix 1, we suggest some of the elements that should be included in such a rule/regulation. To encourage greater stakeholder “ownership” (which can result in greater compliance with securities rules and regulations) we suggest that BSEC: reestablish/reactivate its Advisory Committee - including the adoption of a formal structure, scheduled meetings and agendas - to encourage and solicit *focused discussions* of regulatory policy issues; that it invite representatives of the securities industry to participate in discussions of, or to comment on proposed rules in the *pre-publication* stage; and from time to time, as the need and opportunity arises, that it consider publishing and inviting comment on “*concept releases*”, especially for areas that are to be newly regulated.

2.2 The Mutual Fund Industry – Measures to Encourage Growth

The BSEC CMDMP envisions the adoption of a new legal/regulatory regime for mutual funds that would broaden participation, allow introduction of different types of mutual funds, strengthen investor protections, and eliminate preferential treatment of state sponsored mutual funds (including that these funds observe rules concerning conflicts of interest). It also called for establishing/strengthening an industry association to promote the development of the mutual fund industry. BSEC has adopted a number of

significant changes to the Mutual Fund Rules, 2001 (MFR), consistent with measures proposed in the CMDP II.

The mutual fund industry is now able to operate more flexibly in the pursuit of its business opportunities. While it is still too early to evaluate the impact of the measures providing the industry with more avenues for growth, it can be observed that a number of new mutual funds have been launched during the span since CMDP II. Since the beginning of 2011, the number of licensed Asset Management Companies (AMCs) has increased from 15 to 17 and the number of Mutual Funds has increased from 31 to 41. Assets under management (AUM) have grown from BDT12 Billion in 2009 to BDT 49 Billion as of December 31, 2014.

Despite these positive steps the mutual fund industry is far from realizing its true potential. In comparison to other countries (both regionally and internationally), Bangladesh's mutual fund industry is still at a nascent stage of development. In this section we present an overview and summary of our recommendations to further stimulate the development of the mutual fund industry in Bangladesh. A more comprehensive discussion can be found in Appendix 2 of this report.

2.2.1 Related Party Transactions

We reiterate the recommendation we made under CMDP II to add explicit protections against self-dealing affiliated transactions under the MFR. This would require an amendment to the MFR to add a provision to require written advance third party (SEC or trustee) approval and certification of the fairness and reasonableness of each related party transaction that presents a potential conflict of interests to the mutual fund.

2.2.2 A Broadly Representative Industry Association

Another goal envisioned under CMDP II, with the potential for being of high impact, was the establishment of an effective and broadly representative industry association. This has yet to have been accomplished. The Association of Asset Management Companies & Mutual Funds (AAMCMF), an association comprised of four AMCs, has been registered with the Ministry of Commerce (MOC), and while it represents more than 80 percent of industry AUM, it is not broadly representative, as it does not include a majority of the AMCs comprising the mutual fund industry. – i.e. non-member AMCs far outnumber members.¹¹ In our view, to be effective, an industry association would need to represent a much higher number of AMCs (e.g. 75% of licensed AMCs; or 75% of AMCs managing at least one mutual fund might be more appropriate).

¹¹ Non-member AMCs have questioned the legitimacy of AAMCMF's governance arrangements on the ground that mutual funds are not legal entities and therefore cannot be members of an association.

A well-structured, adequately-resourced, effective, industry-wide mutual fund association could play a significant role in promoting the growth of the mutual fund industry in Bangladesh. Among other things, it could sponsor a national campaign to educate the public about the advantages of long term investing and mutual funds. The need for such a campaign is more evident today, as mutual funds are not well understood and are under a cloud because of the deep discounts at which closed-end funds (which are the dominant type) are trading. An effective mutual fund association could also develop industry standards - e.g., a code of conduct; advertising and valuation standards; a model compliance manual; etc. - and advocate for the industry's common interests and issues of concern to its members.

Because the AMCs that currently comprise the industry are not likely to voluntarily unite to form a single association, we have considered whether and how BSEC could help to bring the factions together. One approach (which we recommend BSEC to consider) would be for it to require that, as a condition of licensing (or alternatively as a condition of approval of a mutual fund), an AMC be required to be a member of an industry association that meets criteria specified by BSEC.

2.2.3 Repurchase Program for Closed-end Mutual Funds

In view of the negative impact that closed-end funds trading at deep discounts to NAV has had on the public perception of mutual funds, we suggest that BSEC consider adopting a rule that permits closed-end funds to make tender offers, as part of a repurchase program, to buy-in their own units at NAV. Allowing a maturing closed-end fund the option of adopting a periodic repurchase program, rather than requiring it to redeem all of its outstanding units or to convert to an open-end fund, relieves the market overhang and downward market pressure that a redemption or open-end conversion would create. It also protects against shrinkage of the mutual fund industry. The prospect of tender offers at NAV could also help to improve how closed-end funds are viewed by investors. Because a periodic repurchase program at NAV would practically serve to support the price of a mutual fund's units (as a result of market expectations of periodic tender offers at NAV), the market price for such units is likely to increase, narrowing the discount to NAV.

2.2.4 Uniform Performance Measurement

Investors should be able to rely on standardized performance measurements to compare the past performance of mutual funds and make investment decisions. Without such standards, performance information can be manipulated in an attempt to present it in a better light. At best, this leads to confusion among investors; it can also deceive investors into purchasing units they would otherwise not have considered. To help to avoid deceptive practices, and provide investors with reliable, accurate information on which to make an investment decision, we suggest that BSEC adopt a rule requiring mutual funds to use uniform measurement standards, over standard time

periods, to measure performance.

2.2.5 Exchange Traded and Money Market Funds

The DSE has announced that it is contemplating listing **exchange traded funds** (ETFs). Such funds have become increasingly popular around the world because they are transparent and generally – aided by the arbitrage activity of “authorized participants” (APs) - sell at prices that are very close to NAV. The details of how those funds will be organized, the extent to which their operations would be facilitated by securities lending or through the use of derivatives, and whether APs would need to meet certain qualifications have yet to be determined. However, as explained more fully in Appendix 2, Bangladesh currently lacks the necessary market intermediaries (including strong long term institutional investors); legal and regulatory framework (including transparency requirements; licensing program for APs; rules governing borrowing and lending of securities) to successfully establish and maintain an ETF industry.

At this stage, we would support the concept, and recommend the adoption of a program to develop an enabling environment for ETFs over the medium term. Such a program would, among other things, involve: training the staffs of BSEC and stock exchanges on the operation and regulation of ETFs; drafting and amending rules to ensure that, among other things, APs are properly capitalized and the ETFs are fully transparent, properly valued and minimize tracking error.

Money market funds (MMFs) have provided a convenience for investors and a means of building interest in other mutual funds of the same AMC and thus attracting investors. The successful development of MMFs requires careful attention to a number of difficult regulatory issues: valuation, careful designation of instruments that qualify as investments. While we favor the concept of offering MMFs in Bangladesh, we caution that its execution can be complex and would require considerable and detailed knowledge about the intricacies of MMFs. It would be appropriate to note that a mutually reinforcing virtuous cycle is likely to develop between the development of MMFs and the development of deep and liquid secondary markets for short term government securities – i.e. the repo and reverse repo markets – which would benefit the development of the short end of the risk-free yield curve.

As a first step in developing MMFs, BSEC may wish to consider inviting the BB and major stakeholders (banks, AMCs, etc.) to discuss the benefits and challenges of introducing MMFs in Bangladesh. Upon developing a positive consensus, BSEC might wish to consider amending the MFR with an MMF rule that accords with IOSCO recommendations.

2.2.6 Leveling the Playing Field

We also renew the recommendation we made under CMDP II to level the playing field between the government-sponsored Investment Corporation of Bangladesh (ICB) and private sector AMCs. Pursuant to exemptions from the MFR, ICB Capital Management, Ltd. (ICBCML), a subsidiary of ICB, serves as trustee for ICB mutual funds. It also serves as trustee and custodian to non-ICB mutual funds. As indicated in the Final Report for CMDP II, the MFR envision that independent oversight of AMCs would be provided by an *independent* trustee. The independence of a trustee is crucial for it to be able to act in the best interests of unitholders. If a trustee believes that a mutual fund is not being managed properly pursuant to the MFR, it has a fiduciary obligation to take action to protect unitholders and inform BSEC. The MFR provide independent trustees broad oversight powers to enable them to carry out their responsibilities.

To prevent conflicts of interests and promote trustee independence, MFR 19 (d) disqualifies an entity from registering as a mutual fund trustee if, *inter alia*, it is related to an AMC, stock broker, merchant banker or portfolio manager. ICB, which operates its own AMC, merchant bank and stock broker, would be disqualified from registering as a trustee were it not for an exemption from the MFR. Unitholders of the ICB mutual funds (more than half of the industry) are deprived of this fundamental and essential protection.

We suggest that BSEC give serious consideration to withdrawing exemptions for all mutual funds managed by ICB and ICBAMC that currently permit ICB to serve as their trustee and ICB affiliates to act as custodian and broker-dealer for those funds.

2.2.7 Enhanced Unitholder Protections

To increase investor protections and facilitate the sale of open-end funds, we suggest adoption of the IOSCO standard of forward pricing for open-end funds, which would remove arbitrage opportunities, and of requiring annual updating of prospectuses for open-end funds.

2.3 Bond Market Development

The development of active corporate bond (fixed income securities) markets is critically dependent on the existence of deep and liquid markets for government securities. It is the risk free yield curve that emerges from active government securities markets that establishes the basis on which all other debt (and ancillary) instruments in an economy are priced. In the absence of a risk free reference yield curve uncertainty and opacity prevail in the primary market for corporate debt securities, dampening would-be issuers' interest, and driving them to the banking sector (where there is more certainty and transparency) for their credit requirements. The government securities yield curve is also used by dealers as a major hedging tool for interest rate risk, and as underlying assets and collateral for related markets, such as the repo, futures and options markets.

Probably the most significant challenge in terms of the development of Bangladesh's markets for government securities, and one that is widely recognized by all the key stakeholders, including the GOB, is the lack of development of the institutional investor base and the resulting over-reliance on banks to purchase (and hold) government securities and on National Savings Certificates (NSCs). In 2013, around 85% of the aggregate outstanding stock of government securities was held by the banking system, and the budget deficit was financed as - 53% from Bonds and Bills; 34% from NSCs; and 14% from overdrafts from Bangladesh Bank.¹²

A number of recommendations were made for the development of the bond markets under CMDP II, many of which were focused on measures designed to facilitate the development of deep and liquid government securities markets, and a number of which centered on the primary market for government securities and primary dealers (PDs), a core element of the primary market for government securities. These recommendations were followed up, in a subsequent ADB-supported TA project (Primary Dealer, or PD TA), the objective of which was to review, assess, and recommend initiatives to improve the effectiveness of the primary market with a particular focus on the primary dealer system.

The PD TA reviewed the available data on transactions, concluded that secondary market liquidity was "extremely thin", and went on to further comment that these low levels of activity indicated that "it is neither practical nor realistic to expect primary dealers to be able to sell their bonds which have been devolved upon them into the secondary markets"¹³ The PD TA report made a number of key recommendations for restructuring the primary market, the greater proportion of which included suggestions for a new approach to "motivating" the PDs to assist in the development of the secondary markets by actively developing the demand for government securities among their networks of clients. The consultants subsequently held a number of seminars on the matter with key stakeholders in Dhaka, during which they explained and discussed their principal recommendations.

The Dhaka-based members of our team have been working closely with Bangladesh Bank's Debt Management Department and the MOF team charged with public debt management to help facilitate the implementation of the measures recommended under the PD TA.

In this section we review and summarize suggestions for improving the prospects for developing Bangladesh's bond markets. Many of the suggestions stem from the recommendations made in the PD Report, with which we generally concur. Appendix 3

¹² By way of comparison, National Savings Certificate-like instruments constitute 7.9%, 0.9% and 11.5% of government financing in the UK, US and India respectively.

¹³ See "Primary Dealers in Bangladesh: A Report for the Asian Development Bank", Chris Golden and Con Keating, March 2014

of this report contains a more comprehensive assessment of the challenges to the development of bond markets in Bangladesh and our suggestions for addressing them.

2.3.1 Issuance Strategies to Deepen Benchmarks

Fragmented issues diffuse liquidity and hinder the development of secondary markets. In order to create and deepen benchmark issues, the PD TA suggested that all tenors of 5-year and upwards maintain the same ISIN in tap and for monthly or quarterly auction (or syndication) until a pre-announced amount has been issued. Only then would a new ISIN issue be opened.

We also agree with the suggestion that the infrastructure be put in place to support the existence of a “*when, as and if issued*” (“when-issued”) trading in government securities. The principal benefit of allowing when-issued trading is that it minimizes price and quantity uncertainties, facilitating price discovery and distribution of government securities, reducing underwriting risk and, thus, increasing potential revenue to the government for new issues. By not allowing when-issued trading in government securities, MOF foregoes these benefits. Given the informational value of when-issued trading, we suggest that statistics on all such trading activity be compiled and made available to the market regularly.

2.3.2 Issuance of Floating Rate Notes

Floating Rate Notes (FRNs) offer a range of benefits - to the government, as issuer, and to PDs and other investors. The government may wish to give serious consideration to adding FRNs as a new instrument to the government securities “product line”. These are bonds that pay a variable coupon that is tied to a money market reference rate (such as DIBOR) plus a fixed spread, usually adjusted quarterly.¹⁴ Some advantages of issuing FRNs include low price volatility, which should encourage secondary market trading; and attractiveness to bank PDs, given that they are based on money market rates reflecting their cost of funding.

2.3.3 Syndicating Long Dated Issues

The benefits of syndicated offerings are broadly recognized and well-documented in the PD TA report. We suggest that Bangladesh Bank consider moving to adopt the recommendation of the PD TA to establish at least two groups of banks and or securities houses which would compete to underwrite bonds, on a syndicated basis, in 15- and 20-year maturities. Each group would tender the terms and conditions (essentially price and coupon, but also whether this would be a re-opening of an existing bonds) under which they would be willing to guarantee the delivery of full proceeds on the completion of an offer, subject to an underwriting fee. This method of issuance would

¹⁴ Further work may be needed in examining the options for benchmark rates to be used for FRNs in Bangladesh.

preclude the need for devolvement since the winning syndicate would be bidding for (i.e. underwriting the sale of) the entire amount offered at the winning price/yield.

2.3.4 Evolution of the Primary Dealer System – A Segmented Approach

As recommended by the PD TA, we suggest that the number of PDs be reduced, based on voluntary participation, and split into three groups of PDs, each of which would focus on a different segment of the market for government securities – e.g. the 0-1 year (money markets) segment; 2 and 5 year (medium sector); and 10, 15 and 20 years (long maturities). The PD TA report envisions and outlines a consultation process involving the key stakeholders (i.e. Bangladesh Bank, as the “issue manager”, MOF as the issuer and public debt manager, and the PDs as purchasers). The segmented approach could be established in the aftermath of such a consultation process.

2.3.5 Rules to Allow for Short Selling, Borrowing & Lending

In order for PDs to fulfill their “dealer” role, they will need to make two-way markets in the maturities of their choice. The ability to borrow and sell short government securities is essential to managing the risks inherent in holding large inventories of government securities. We suggest that BSEC and Bangladesh Bank collaborate in developing and adopting a coordinated rule to allow for short selling and borrowing and lending of government securities for *market makers* in the ordinary course of their business. Active arbitrage and market-making would also support the development of ancillary markets - i.e. the market for securities lending or reverse repo. To make delivery and settle short sales it is necessary for the market maker or arbitrageur to borrow these securities.

2.3.6 Fiscal Incentives to Catalyze the Growth of Bond Mutual Funds

The emergence of mutual funds that primarily hold government and other debt securities as investments (i.e. bond mutual funds) has been constrained for a number of reasons. To stimulate the growth of bond mutual funds, a measure that could be considered would be to provide a tax exemption on interest income to unit holders of this type of mutual fund. The amount would need to be the subject of study. The principle of “tax neutrality”, to which we adhere, suggests that it should be at least equal to the exemption enjoyed by unit holders in equity mutual funds (they are exempt from taxes on the first BDT 25,000 in dividends). Higher tax incentives may be considered, however our suggestion would be that such incentives are accompanied by a “sunset provision” making them self-expiring after some predetermined period – e.g. five years – during which time it might be reasonable to expect that the mutual fund sector would have grown to a critical mass.

2.3.7 Funding Options for Public and Private Pension Systems

Pension funds are perhaps the most natural buyers of government securities. The absence of developed pension systems is perhaps one the most significant missing links

in improving liquidity. We have been apprised that Bangladesh Bank is considering an initiative to develop regulations requiring banks to establish employee provident schemes/pensions.¹⁵ This may be extended to the broader corporate sector. A subset of the existing asset management industry could also be encouraged to specialize in pension fund management as is the case in regional practice. We would suggest that any incentives should be considered as an element of a more comprehensive government policy and strategy for pension reform.¹⁶

2.3.8 Encouraging Broader Retail Distribution of Government Securities

Given that the development of a base of stable and resilient institutional investors for government securities takes considerable time even in the most conducive policy environments, in addition to the reforms of the PD system, we suggest a more focused effort to encourage retail demand for government securities. This could also serve to reduce reliance on National Savings Certificates. One suggestion to consider might be to broaden the distribution network beyond the primary dealers and encourage brokerage firms and merchant banks to sell government securities. There should also be a greater effort to educate retail investors on the benefits of investing in government securities relative to alternative investments. PDs and brokers-dealers can be supported and encouraged by Bangladesh Bank in their efforts to offer such investor education programs.

2.4 Developing the Insurance Industry

Considerable progress has been made in liberalizing and modernizing the insurance industry by adopting two new insurance laws, establishing a new regulatory authority, and adopting a national insurance policy. In Appendix 4, we suggest a set of next critical steps that include enhancing the operational effectiveness of the regulator - the Insurance Development and Regulatory Authority (IDRA) - that will empower it to implement the required policy and regulatory reforms envisioned by the National Insurance Sector Development Policy (NISDP). In this respect, strengthening the industry – both from the perspective of its financial health and its technical capacity – should be a first-order priority and is consistent with the NISDP.

2.4.1 Enhancing IDRA's Operational Effectiveness

The International Association of Insurance Supervisors (IAIS) is the internationally recognized standard-setting authority for the supervision of insurance industries. IAIS Core Principle 2.4 (IAIS CP2.4) lays the foundation for supervision of the insurance sector. It establishes the following standard for insurance industry supervisors:

¹⁵ It is not clear whether the scope of this initiative may be limited to public sector banks, or if it would be intended to apply to all scheduled banks.

¹⁶ Appendix 5 of this report contains our assessment and recommendations for developing the pension sector.

“The supervisor and its staff are free from undue political, governmental and industry interference in the performance of supervisory responsibilities. The supervisor is financed in a manner that does not undermine its independence. The supervisor has discretion to allocate its resources in accordance with its mandate and objectives and the risks it perceives.”

To insulate IDRA from undue external interference, and to ensure conformity with the IAIS CP 2.4, we suggest legislative amendments be enacted that provide IDRA with rule- and regulation-making authority; delegated procurement authority; and ensure that it has an independent source of revenue, over which it has full authority. We were advised of an initiative already underway to amend the IDRA Act and the Insurance Act, which may serve to expedite and facilitate the adoption of the above-suggested amendments.

2.4.2 Other Legislative Action Required

Under the assumption that legislative initiatives are not precluded, the following amendments should be made to enhance competition and further liberalize the insurance industry:¹⁷

- Amend Section 17 of the Insurance Act to provide a "sunset clause" that phases out the Central Rating Committee (CRC) within 5 years (or by 2020);¹⁸
- Amend the Insurance Act to repeal the maximum commissions and maximum expenses provisions (sections 58 & 62). Recognizing that it may be necessary to cap commissions and expenses in the short run, we propose addressing these limits *through regulation* that may also include a sunset clause that phases out these limits over a reasonable time frame. Ultimately, these should be market-driven.¹⁹

2.4.3 Adoption of Pending Rules/Regulations

While considerable progress has been made in establishing IDRA as the regulatory authority for the insurance industry, we are informed that some of its key initiatives are hamstrung as a result of some of the key regulations required to be adopted by IDRA under the Insurance Act pending government approval, and that some of these approvals may have been pending for considerable lengths of time. We would, therefore, suggest that the government expedite the approval of these regulations, especially those that have been pending approval for 90 days or longer, or, if it has any

¹⁷ There may be other areas, such as the removal of conflicts with other legislation (i.e. the law governing microfinance apparently allows MFIs to offer insurance products, and may need to be reconciled/rationalized). We are informed that IDRA has already conducted a thorough analysis of the IDRA Act and the Insurance Act, and may be consulted prior to finalizing any legislative proposals.

¹⁸ The reader is referred to Insurance Sector White Paper, 2012 for a more complete discussion of the need for this.

¹⁹ *Ibid*

concerns, that it communicate the reasons for its concerns to the IDRA so that it may consider the government's views in finalizing these regulations.

At a minimum, we suggest focusing on those pending rules/regulations that would have the greatest impact on the development of the industry, and would allow for implementation of the initiatives envisioned for Phase 1 of the NISDP Road Map. In Appendix 4 we suggest some of the pending regulations that may be included in a "critical list". These include regulations governing: paid-up capital and share holdings of an insurance company; appointment of consultants or advisors (by IDRA); the life insurance Policy Holders Protection Fund (PHPF); the three related regulations for licensing brokers, life and non-life agents; and the two regulations addressing reinsurance for life and non-life business.

2.4.4 Recapitalizing & Commercializing the State-Owned Insurers

In accordance with the NISDP, we suggest that MOF, with advice from IDRA, develop and adopt an approach and plan to commercialize both state-owned insurance companies (SOICs). This should, at a minimum, involve/include: independent determination of the true financial condition of the SOICs, and extent (if any) to which their capital is deficient/impaired; developing and executing a credible "capital restoration plan" to bridge the solvency gap; and developing and executing a commercialization plan with appropriate structural and administrative reforms.

2.4.5 Recapitalizing the Private Insurance Sector

The NISDP contemplates strengthening the private insurance sector by the adoption and adherence to a more dynamic capital standard, and facilitating capital enhancements. We suggest that IDRA design, adopt and implement a plan to improve the financial health of weak insurers as this may be holding back the industry, as a whole, from realizing its considerable potential. This plan should include: a two-tiered approach to determining minimum regulatory capital requirements for each insurer; a requirement for capital-deficient insurers to develop, and obtain IDRA approval for credible capital restoration plans, with specific quantifiable intervening milestones, to be monitored closely and regularly by IDRA, with prior agreement on course of action to be taken in the event of default.

2.4.6 Acquisition of a Regulatory Information & Data Exchange Facility

In support of its eventual transition to a risk-based approach to supervision (RBS), and to facilitate the timeliness and accuracy of regulatory filings made by the industry that would enable the close and regular monitoring of high-risk entities, IDRA should acquire and deploy a regulatory information and data exchange facility (RIDEF). We have identified the different stages and steps involved in this in Appendix 4.

2.4.7 Other Areas

Appendix 4 addresses other issues and areas of concern, providing suggestions/recommendations in the following areas: tariffication and the Central Rating Committee (CRC); the education/training conundrum and Bangladesh Academy for Insurance Studies (BAIS); the acute shortage of actuaries; agency status; and taxation issues.

2.5 Pension Reforms

Our stakeholder consultations suggest that, until recently, the issue of old age income provision/security has not been the subject of considerable official discussion or analysis in Bangladesh. However, demographic, urbanization and other trends may be signaling a shift in this situation. Increasing rates of aging and urban migration may portend a growing interest in and support for pension reform. Indeed, one of our final meetings with MOF officials directed our attention to a draft *National Social Security Strategy (NSSS)*, which includes a section devoted to the notion of developing a comprehensive pension system for elderly.²⁰ It proposes developing a comprehensive pension system that provides a state-guaranteed minimum income for senior citizens belonging to the poor and vulnerable group, while building a contributory pension system for those working age families who want to provide for themselves a higher level of pension income in old age. It points to facilitating the development of capital markets as one of the ancillary benefits of a funded pension system as the accumulation of significant pools of funds can be used for investment in enterprises and to support national development. The following 3-tiered pension system is envisioned:

Tier 1: A Citizen's Pension - A public expenditure-financed benefit that provides senior people that belong to the poor and vulnerable group with a minimum income guarantee;

Tier 2: The National Social Insurance Scheme (NSIS) - A mandatory contributory pension scheme for formal sector workers. It appears that the proposal is for the NSIS to include government workers, but that the government would maintain existing pension commitments to civil service employees.

Tier 3: Private voluntary pension (PVP) schemes – managed by the private sector (often employment-based schemes) – into which people can opt if they desire additional income in old age.

The NSSS envisions that the Citizen's Pension and the Government Service Pension Plan would be funded by the National Budget. The NSIS and the PVP would be funded through employer and employee contributions.

²⁰ While we have been provided a copy of the Draft National Social Security Strategy, despite several attempts, it was not possible for our team to meet and engage in discussions with any of the officials of the General Economics Division of the Planning Commission.

With respect to the National Social Insurance Scheme (NSIS), the draft NSSS envisions the introduction of enabling legislation that makes it obligatory for all private enterprises in the formal sector to offer a contributory pensions program for all employees. It also envisions that the NSIS would provide pensions and address other contingencies (such as disability, sickness, unemployment and maternity) and that it would be *regulated* by the Insurance Development & Regulatory Authority (IDRA).²¹

With respect to Private Voluntary Pensions (PVP), it is envisioned that an assessment would be required of options to facilitate the development of PVPs, which would be open to participation by all citizens, irrespective of occupation or formality of employment.

Assuming the proposals made in the draft NSSS are adopted, we would envision the potential for considerable synergies between the NSSS and the initiatives ADB is supporting for the development of the capital markets. We would envision that Tiers 2 and 3 of the contemplated 3-tiered program would be most relevant to the scope of the CMDP III program.

2.6 Private Equity and Venture Capital

Private equity (PE) is medium to long-term finance provided in return for an equity stake in potentially high growth unlisted companies.²² PE is an important source of funds for start-up firms, private middle-market firms, and public firms seeking buyout financing. Over the past twenty years it has been the fastest growing source for corporate finance – growing faster, by an order of magnitude, than other sources such as public equity and bonds and privately placed debt. In addition to being a source of risk capital, PE firms can help to stimulate private and financial sector development through due diligence-Induced improvements; dissemination of best practices; and stimulation of private and public capital markets as exit strategies are executed.

Annual PE investment in emerging markets is estimated at USD 30 – 40 billion, much of it from foreign sources. As a “frontier” market, Bangladesh should be capturing a fair share of this global pie, but, while growing, the PE industry in Bangladesh is still largely at a nascent stage with only around USD 100mn of committed capital from non-DFI, Bangladesh-focused private equity and venture capital funds.

In Appendix 6 we examine some of the possible reasons for this and offer some suggestions for policy, legal and regulatory measures that could serve to mitigate concerns private equity investors might have. These are summarized below.

²¹ While the term “managed” is used in the NSSS report, we have interpreted this to mean “regulated” as it would be impractical for the IDRA to “manage” a NSIS.

²² To avoid confusion, we use the term “private equity” (PE) to describe the industry as a whole, encompassing both “venture capital” (i.e. capital invested in the seed to expansion stages) and buy-ins and management buy-outs.

2.6.1 Opportunities for Enhancing the Enabling Environment

Based on consultations with various stakeholders and our own analysis and assessments we list below some of the key areas that may need to be addressed with a view to providing more clarity and certainty, and enhancing the enabling environment for PE.

2.6.1.1 Private Equity Development Policy

We recommend that the government consider the adoption of a PE sector/industry development policy that seeks to resolve and remove impediments (for both local and foreign PE investors) in the legal, regulatory and policy frameworks, as this may provide the type of impetus needed to attract interest from PE investors. The initiative to develop such a policy may be led by the Board of Investment (BOI) but, due to the multi-faceted nature of PE investing, may also require the active participation and involvement of an inter-agency group which may include the MOF, MOC, NBR, Bangladesh Bank, and BSEC.

2.6.1.2 Legal & Regulatory Frameworks for Private Equity

Private equity firms do not have the benefit of a specific legal and regulatory regime for PE, and operate within parameters provided by general laws and regulations, some of which may be constraining the development of PE in Bangladesh. In particular we would point to: the need to provide clarification/relief in tax treatment; challenges in the execution of exit strategies; and obstacles to the repatriation of capital for foreign PE investors.

In order to provide clarity and certainty to PE funds, we recommend that the government consider developing a comprehensive legal/regulatory framework for the PE industry. In Appendix 7, we outline, in some detail, some of the areas in which such clarity and certainty may be required. These are summarized below.

Tax Treatment of PE Fund Structures - The use of the trust structure as an investment vehicle is common in Bangladesh (e.g. mutual funds), and while the trust structure is broadly appropriate for PE, taxation at both trust and investor levels potentially renders the trust structure uneconomic for use in the PE industry.²³

Thus, we suggest that, in devising the legal and regulatory framework for PE, drafters seek a solution that addresses and resolves the matter of “double taxation” in a manner that would allow for the trust structure to be utilized. One way of achieving this objective is to designate entities established with the limited purpose of holding investments – i.e. those that pass through substantially all of the economic benefits of such holdings (e.g. 80 to 90 percent of revenues received) to PE investors - as exempt from taxation at the entity level, and that taxes on such economic benefits be imposed

²³ The alternative to a trust structure - a limited partnership - is not nearly as robust, and may not provide the requisite protections, clarity of benefits, obligations, roles & responsibilities of the parties that are provided under the Trust Act.

only at one level – that of the PE investor who derives all such benefit from these investments - i.e. such entities to be accorded “pass-through” tax status. Our preliminary discussions with NBR indicate a positive willingness to consider such an approach.

Exits through Initial Public Offerings (IPOs) - The final/medium term objective of an investment by a PE fund is to make a reasonable gain/return on that investment. These returns are realized through the divestment/sale of the PE fund's interest in investee companies (i.e. “exits”). Our consultations/assessments have pointed to a number of potential obstacles to the successful execution of some of the available exit strategies.

IPO Lock-Ins - At the time of an IPO, PE funds that have an ownership stake in the company offering its shares to the public are considered “sponsors” in accordance with securities regulations, and are subject to a 3 year “lock-in” during which time they are restricted from selling their shares.²⁴ If they hold more than 5% of the company's shares they are prohibited from selling such shares during the lock-in period. This effectively extends the duration (by as much as 35 – 40%) of such investments which, in turn, raises the level of uncertainty/risk associated with them (as the PE fund may no longer hold a large enough interest in the company to “monitor” its management), thereby raising the level of return required by the PE fund. Higher return requirements effectively “shut out” all but the most qualified firms, narrowing investment options, and thus, the scope for establishing an active PE industry.

We suggest that, because of the constructive role they play in filling a void – i.e. providing “risk capital” to SME's, an important engine of economic growth - there may be sufficient justification for treating PE funds differently than the typical “sponsor”, and that consideration may be given to exempting legitimate, bona fide PE funds from the lock-in period, or reducing it to a maximum of 1 year.

2.6.1.3 Repatriation of Capital

Domestic PE funds can make investments in the form of equity, preference shares, convertible preference shares, bonds and other debt instruments. In contrast, foreign PE investors are precluded from utilizing bonds and other debt instruments by virtue of the fact that only investments made in the form of straight equity shares are eligible for the repatriation of the proceeds of the sale of such shares without prior regulatory approval from Bangladesh Bank.

Convertible preference shares are an attractive investment instrument for PE funds as they perform a hybrid function - initially they have many of the characteristics of debt with an agreed coupon and redemption, but they also can be converted into equity shares based on predetermined/negotiated criteria. We suggest that, in order to allow foreign and domestic PE investors to compete on a level playing field,

²⁴ Bangladesh Securities and Exchange Commission (Public Issue) Rules-2006

the repatriation rules be amended to facilitate the use of the full range of instruments typically used by PE investors globally – i.e. equity as well as convertible bond, debt, hybrid and/or mezzanine instruments.

Also, in the event that a planned IPO does not materialize, and a foreign PE fund must resort to alternative exit routes, foreign exchange regulations require that permission for the repatriation of the proceeds of such sale (e.g. sponsor buy-back) be secured *by the investee company*. This procedure has proven to be problematic when the investee company has either delayed the process, or has been unwilling to apply for this permission (e.g. in the event of a dispute having arisen between the two parties). We suggest that a mechanism be developed whereby the PE fund may apply *directly* to BB for authorization to repatriate in such instances.

Repatriation of capital is a natural and understandable concern for foreign PE funds. Addressing the above mentioned concerns may serve to stimulate the interest of a greater volume of foreign investment in the form of private equity.

2.6.1.4 IPO Pricing

There is a concern amongst PE funds that, under the current IPO pricing methodology, IPO pricing at exit may be below “fair market value”, as the price discovery mechanism used is not sufficiently market-driven, making it difficult for PE firms to operate. PE funds would welcome a methodology which provides for a price discovery mechanism that is more market-oriented. While we are aware of the abusive practices that led to the suspension of price discovery through the “book-building” method, we, nonetheless, suggest that BSEC consider amending the IPO rules to allow for a price discovery mechanism that is more closely aligned with “fair market value”.

2.7 Derivatives

As a class, derivatives are among the fastest growing financial instruments globally. By providing firms with new and more effective tools for managing exposure to various risks (e.g. adverse fluctuations in interest rates, foreign exchange rates, and commodity prices), derivatives can reduce the likelihood of financial distress due to volatile prices and interest rates.

Efficient derivatives markets require deep and liquid spot (“cash”) markets for their “underlying” instruments/assets from which to draw pricing information. While it is not likely that the situation in Bangladesh will meet the minimum conditions required for the successful introduction of derivatives for some time, there is a renewed level of interest - by the regulator and by private interests who could potentially sponsor a derivatives exchange. Although the introduction of derivatives in Bangladesh may be a long-term proposition, the gestation periods to bear fruit in many of the areas are quite long, and require considerable advanced planning and coordination, so it may not be too early

to start moving forward on a number of fronts. In Appendix 7, we explore areas in which CMDP III may support the development of an enabling environment for the introduction of derivatives in Bangladesh. These are summarized below.

2.7.1 Demand Study

We recommend that a demand study be conducted to carefully examine and seek to quantify the potential demand for a range of possible instruments. Such a study could be done as a separate exercise, as a precursor to, or in conjunction with, the development of a Derivatives White/Policy Paper (discussed below).

2.7.2 Policy Framework

We recommend the adoption of a policy framework that establishes the basic principles on which derivatives and associated markets and infrastructure will be developed and identifies the principal actors and their roles and responsibilities in this regard. As a first step, a policy/white paper should be drafted for adoption by the government. This would considerably facilitate an orderly principles-based approach to the development of derivatives and associated markets. Depending on the timing of this exercise, ADB may wish to consider including the adoption of a Derivatives White/Policy Paper as a second Tranche Policy Action in connection with the CMDP III Policy Loan.

2.7.3 Strategic Plans

As part of the strategic planning described in Section 2.1.1.1, BSEC may consider including the following elements for the development of derivatives and associated markets in its overall strategic plan:

- A strategic plan for putting in place the requisite “soft” infrastructure to include the legal, regulatory, and policy frameworks
- A strategic plan for engaging with private sector stakeholders, to inform and educate current and potential stakeholders on the benefits and risks of derivatives.

2.7.4 Developing Supportive Financial Market Infrastructure

We suggest establishing a central clearing organization, which would allow the netting of cash and securities obligations. This makes for more efficient use of resources and increases arbitrage opportunities, leading to more efficient markets overall. It also facilitates the eventual introduction of a central counterparty (CCP), which effectively eliminates settlement risk, provides trading anonymity, makes settlement operations more efficient, and is a necessary prerequisite to the introduction of derivatives and derivatives markets.

2.8 Central Clearing

The current clearing and settlement process for equity securities in Bangladesh exposes the two stock exchanges to considerable risk and may impact the perceived stability of Bangladesh's capital markets in times of market stress. Should a participant fail to fund settlements or deliver securities, the stock exchanges are exposed to residual default risk as they are tacitly regarded as "guarantors" and will need to settle these transactions. However, there is no certainty that the exchanges will have the financial capacity to do so, as the current Settlement Guarantee Funds (SGFs) may not be sufficient to cover such defaults. Furthermore, the current clearing and settlement arrangements: duplicate clearing and settlement infrastructure at DSE and CSE; lack "delivery versus payment" (DVP) for indirect market participants; require participants to provide cash and securities in advance of the settlement date; and lack "straight through processing" (STP), requiring manual rekeying of orders and file transmission, and increased operational risk.

The DSE and CSE recognize these risks and have signed a memorandum of understanding (MOU) setting out proposals to develop a new entity to formally take responsibility for the clearing and settlement function via a new clearing and settlement company (CLEARCO) jointly owned by the two exchanges.

In 2014, BSEC formed a committee to investigate and report on the development of a central clearing facility (as a central counterparty – CCP) for the market as part of the planned development of derivative markets. It has also recently formed a committee to examine the level of ongoing risk based capital adequacy (RBCA) that licensed securities entities (including DSE and CSE participants) should maintain.

To facilitate a move towards the development of derivative products and to facilitate the development of a central counterparty (CCP) clearing facility, a critical first step will be for the current equity clearing and settlement process to be enhanced by the introduction of an independent, well capitalized CLEARCO employing modern risk management disciplines and mechanisms, with access to an adequate SGF. This would pave the way for the eventual introduction of a more complex clearing mechanism - a central counterparty (CCP) clearing facility - which is an essential prerequisite for the development of derivatives markets in Bangladesh.

By firstly moving to enhanced clearing and settlement through the development of a National Clearing and Settlement System owned and operated by CLEARCO - and, in due course, facilitating CLEARCO's transition to a CCP - Bangladesh can considerably improve its clearing and settlement infrastructure, reduce risks to the exchanges, their participants, investors and regulators, and will have taken a big step toward the orderly and sustainable introduction of derivatives.

In Appendix 8, we identify several initiatives that would need to be undertaken in the short (next four to six months) and medium term (twelve to eighteen months) and areas in which ADB could provide technical assistance over the next eighteen months. These are summarized below.

2.8.1 Short Term Initiatives (next 4-6 months)

BSEC should seek to finalize and implement Risk Based Capital Adequacy (RBCA) standards for TREC holders (and other licensees). This should include clarification of capital requirements for margin finance activities and should coincide with lifting the suspension of Section 3(5) of the Margin Rules, 1999. Furthermore, DSE and CSE should be required to actually deposit the amounts agreed, as part of the demutualization process, to the Settlement Guarantee Fund. BSEC would need to promulgate regulations to govern the National Clearing and Settlement System and establish a time-bound action plan for the stock exchanges to complete the incorporation, capitalization, licensing and establishment of CLEARCO. BSEC would also need to develop and adopt stock borrowing and lending as well as short selling rules that support continuous net settlement and allow clients to sell short equity securities subject to certain restrictions. These clarifications would also tend to have the effect of increasing the volume of transactions on the stock exchanges, as they would enable intraday transactions which are not currently possible due to the limitations of the current clearing and settlement mechanism.

2.8.2 Medium Term Initiatives (next 12-18 months)

It would be reasonable to expect that CLEARCO could be established and be operational (providing "enhanced clearing" services to market participants) within the medium term (12-18 months). CLEARCO would need to be staffed with independent professional management, have developed and implemented appropriate risk management mechanisms, and have acquired and deployed adequate IT systems to support its operations. Furthermore, initiatives should be undertaken within the medium time frame to advance the objective of establishing a CCP. These would include: the adoption of new laws (or amendment of current ones) concerning bankruptcy that provide for the "carve-out" of priority rules for a CCP; consideration and agreement on steps for CLEARCO to use Central Bank funds for settlement via access to the RTGS system as a "quasi-bank"; undertaking an actuarial study and implementing the recommended levels of capital and SGF contributions for clearing participants; improving linkages with CDBL and RTGS to ensure STP and finality of DVP; and capacity building for CLEARCO and BSEC relating to the operation of enhanced clearing and settlement as well as the needs and operation of a CCP.

2.9 Developing the Market for Sukuk

Sukuk is a generic term used to encompass a broad range of financial instruments

designed to conform to the principles of Islamic law (Shariah). They are, in many respects, similar to conventional asset-backed securities (ABS). In recent years, Sukuk have gained in popularity throughout the Islamic (and non-Islamic) world.

While the rapidly growing Islamic banking industry in Bangladesh would suggest that there may be a healthy demand for Sharia-compliant capital market instruments, with the exception of a few GOB-issued instruments, Sukuk are largely absent from Bangladesh's financial landscape. Given the potential for strong demand, we have been examining and assessing the prospects for their introduction in Bangladesh and surmise that one of the key binding constraints to the supply of Sukuk may be the lack of clarity and certainty – from the perspectives of potential issuers and investors – with respect to the legal, regulatory, and Shariah treatment of Sukuk. In Appendix 9, we offer suggestions for a possible path to developing a market for Sukuk in Bangladesh. These are summarized below.

2.9.1 Legal Regulatory and Policy Framework – Developing an Enabling Environment

We surmise that the absence of a legal and regulatory framework is one of the factors inhibiting the issuance of Sukuk. While many Sukuk are designed to replicate the economic function of conventional bonds, their legal structures are quite different. There are complex legal (and other infrastructure) requirements for the “securitization” of tangible assets through Sukuk. Although the GOB has issued Sukuk from time to time, there are presently no regulations for Sukuk issued by the private sector. It would be difficult to imagine a scenario in which the market for Sukuk would spontaneously develop in the absence of such clarity, thus, a critical first step to developing a market for Sukuk would be to clarify the treatment of Sukuk structures under the law.

There are essentially two options for Bangladesh in this respect. The first would be to try to accommodate these instruments under existing legal and regulatory frameworks through the introduction of legislative and/or regulatory amendments. The second would be to develop an entirely new legal and regulatory framework for Sukuk, which could either be dedicated solely to Sukuk, or could potentially encompass a wider range of Islamic financial instruments.

While the first option would be consistent with the regulatory approach Bangladesh has taken for Islamic banking, classifying Sukuk under existing frameworks has posed challenges in other jurisdictions, and may not prove to be the optimal solution for Bangladesh. Although it is beyond the scope of this assignment to specify the elements (i.e. laws and regulations) that should comprise Bangladesh's legal & regulatory framework for Sukuk we suggest that the two principle objectives of such a framework should be to: a) seek to introduce clarity; and b) seek to create a level playing field between comparable instruments of similar economic substance.

In general, the aim of a legal/regulatory framework should be to lay down guidelines and operational frameworks for Sukuk. It should involve all stakeholders and cover all aspects - from product structuring, issuance and marketing, to dispute settlement, and should specify each party's rights, address each of its stages, and provide for robust enforcement arrangements. It may be helpful if the legal/regulatory framework were to specify some degree of standardization for the underlying assets, the process of their valuation, the rating process, the Shariah approval process, and the documentation that would be required at each stage of the transaction.

As Shariah is the backbone of Sukuk, a solid legal/regulatory framework for Sukuk should be built on Shariah concepts and rules. Clarifications may include aspects such as Shariah standards, Shariah governance and compliance frameworks. Dispute resolution mechanisms - whether through the court system or through reference to Shariah-compliant alternative dispute resolution mechanisms such as *tahkim* (arbitration) or *sulh* (mediation) – should also be considered. It may also be necessary to establish a central Shariah board that exclusively addresses matters concerning Sukuk.²⁵

Sukuk involve many stages, including the origination of eligible assets, the sale of these assets to a special purpose vehicle, the sale of interests in the pool of assets to end investors, the lease-back of the underlying assets to the originating entity, and all of the financial “flows” generated throughout the Sukuk's lifecycle. To provide certainty to potential originators, issuers and investors, we suggest that the application of taxes (e.g. stamp duty, capital gains taxes, income taxes, and other taxes) to each stage of a Sukuk transaction be clarified in a durable manner – i.e. through durable regulatory or legislative action.

2.9.2 Promotion and Marketability of Sukuk

Being a new instrument in Bangladesh, initiatives may need to be taken to promote Sukuk. Below is a list of some of the initiatives to be considered this respect.

Government initiatives - Measures to improve liquidity of existing Bangladesh Government Islamic Bonds; development of new Islamic Treasury instruments; creation of Islamic Repo markets; government issuance of *Ijarah* Sukuk for project financing.

Corporate initiatives - Large corporations may need to be encouraged to issue Sukuk as a means of funding their long term financing for large projects such as power and other infrastructure projects;

Other initiatives - Initiatives to assist in developing the knowledge and understanding of Sukuk instruments among credit rating agencies; establishing an Islamic Finance Academy; establishing and maintaining linkages with international Shariah bodies.

²⁵ The suggestion has been made that the Central Shariah Board for Islamic Banks of Bangladesh may be expanded to serve this purpose.

APPENDIX 1

LEGAL, REGULATORY & POLICY ISSUES

APPENDIX 1: Legal, Regulatory & Policy Issues

1	Introduction	1
1.1	Consolidating Achievements Made Under CMDP II	1
1.2	Organization of this Document	1
2	Making Rules and Developing Legislation	2
2.1	Office of General Counsel.....	2
2.2	Regulatory Policy Coordination	3
2.3	Promoting the Understanding of Laws and Regulations.....	6
3	Authorization of Participants and Practices	9
3.1	Certification of Professionals	9
4	Monitoring and Investigating Market Participants	11
4.1	Market Surveillance	12
4.2	Stock Exchange Oversight	12
4.3	Building Capacity.....	14
4.4	Inspections of Market Intermediaries	15
4.5	Strengthening Intermediaries – A “Three Legged Stool” Approach.....	16
5	Enforcing Laws and Regulations	23
5.1	Cases Brought Under the Public Demand Recovery Act.....	24
5.2	Strengthening Enforcement – Augmenting the Legal Staff	26
5.3	Operationalizing the Special Capital Market Tribunal	27
5.4	Enhancing the Quality of Financial Reporting	31
5.5	Reporting and Recovery of Short Swing Profits	44
5.6	Take-over Rule.....	49
6	Market Development & Promoting Education & Understanding	50
6.1	BSEC’s Investor Education Program	51
7	Organizational Challenges	54
7.1	Operational Independence – Delegated Procurement Authority	55
7.2	Operational Independence - BSEC’s 10-yr Organogram.....	56
7.3	External Interference.....	56

7.4 Organizational Structure	57
7.5 Long Term Planning	58
7.6 Integrating Information and Communications Technology (ICT)	59
7.7 Institutional Integrity	60

APPENDIX 1: Legal, Regulatory & Policy Issues

1 Introduction

TA 7811-BAN produced a master plan (CMDP2MP) that focused on five strategic objectives. At its foundation was the rehabilitation of the BSEC, including securing its operational and financial independence, strengthening its organizational structure, enhancing the quantity, quality and skills of its staff and improving its information and internal control systems. Building on a strengthened BSEC, CMDP2MP sought also to strengthen the rules and regulations relating to capital markets, upgrade financial market infrastructure, and create an environment that would enable the orderly and sustainable emergence of new products (e.g., corporate bonds, asset backed securities and other derivatives) and the expansion of institutional investors' (e.g., mutual funds, insurance companies and pension funds) participation in the capital markets. CMDP2MP formed the foundation on which the BSEC's own master plan was developed. Its master plan was adopted in October 2012 as the BSEC Capital Market Development Master Plan (CMDMP).

1.1 Consolidating Achievements Made Under CMDP II

A number of critical and important advances/achievements were made under CMDP II that have the potential for setting the capital markets on a path to more sustainable development. A number of these achievements, however, only partially addressed critical issues. This report addresses the areas in which more needs to be achieved to ensure progress made under CMDP II is institutionalized and the risk of "policy reversal" is mitigated.

1.2 Organization of this Document

In what follows, we address areas related to the legal, regulatory and supervisory frameworks for Bangladesh's capital markets. We use the five principal functions/roles of a capital markets regulator as a way of organizing our analysis and categorizing our recommendations. We examine the following five principal functions:

- Making rules and developing legislation;
- Authorizing participants and practices;
- Monitoring and investigating market participants;
- Enforcing the laws and regulations; and
- Educating and informing market practitioners and the investing public.

In each of the five sections we first briefly define the role/function, and then provide our analysis of areas in which deficiencies/challenges remain. We follow these discussions

with recommendations for reform initiatives, and specifically identify areas/situations that may produce attractive candidates for the ADB to consider adopting as Policy Actions for the forthcoming CMDP III Policy Loan. We also identify potential opportunities for “Piggy-Backed” and “follow-on” technical assistance.

A final section addresses cross-cutting issues. In it we discuss some of the issues remaining from CMDP II, which, if left unaddressed, could threaten to reverse much of the progress made under CMDP II and many of its hard-won achievements.

2 Making Rules and Developing Legislation

The first of the essential functions of a securities market regulator is its ability to make rules and develop legislation. Rule-making and legislative functions require:

- Links with government policy making and international bodies;
- The ability to facilitate private stakeholder involvement;
- Independence and an absence of conflicting roles; and
- Input into the law reform process.

Understanding, interpreting and drafting laws and regulations, persuading others of the meaning and/or need for such laws and regulations require a legal background. It is most appropriate that the portion of this report focused on BSEC legal and regulatory matters starts with a discussion of the necessity for the BSEC to create an Office of General Counsel (OGC) and a discussion of the role that lawyers could play in improving the effectiveness of the BSEC.

2.1 Office of General Counsel

The BSEC's long term effectiveness and its ability to promote and comment on legislation that affects its responsibilities; promulgate rules; investigate violations of the securities laws; build and successfully resolve enforcement cases; and adopt and maintain international best practices would be markedly strengthened by establishing an Office of General Counsel and engaging a full staff of lawyers. The BSEC's proposed (10 year) organization chart (organogram), awaiting approval by the Ministries of Public Administration and of Finance, contemplates a 37 person Law Division, including 19 in a Legal Services Department. However, if approved, this organization chart will not take full effect for many years.

The BSEC has recognized that more immediate steps are necessary to strengthen its legal capacity, whether to enhance its rule-making and legislative impact or to fortify its capacity to enforce the laws. The BSEC's CMDMP stated:

“We recognize that the SEC is, at its core, a law enforcement agency, yet it does not have a General Counsel, and has very few lawyers on its staff. This is a serious deficiency which significantly reduces the (B)SEC’s effectiveness, not only in making rules and developing legislation, but in conducting investigations and in enforcement.”¹

Initiative 19 which addresses this need states: “Establish an office of Chief Counsel and recruit attorneys”.² The BSEC would benefit in both the short and mid-term, by utilizing its increased financial and hiring flexibility and its ability to offer salary and benefits equivalent to the BB’s, to immediately plan and undertake a focused campaign to engage a General Counsel and add lawyers to the BSEC staff.

2.2 Regulatory Policy Coordination

Regulation of the securities markets cannot be developed in isolation from general governmental policy and the generic law that applies to securities markets. Understanding of public policy principles and the government’s broad policy aims, and an ability to understand and justify policy in terms of relevant ministries’ policy priorities, is essential for effective policy development.

It is also essential that regulatory policies be developed through open and consistent dialogue (i.e. linkages) with other financial market regulators. Establishing and strengthening these linkages is critical to BSEC’s success in fulfilling its law and rule-making role. The BSEC’s CMDMP recognized the importance of improving regulatory coordination. It stated:

“One of the factors contributing to the market volatility of 2010/11 was the lack of coordination between the SEC and Bangladesh Bank. Several initiatives in the attached Plan of Action are designed to help improve this interagency coordination. It is expected that implementing these recommendations will result in better coordination among the financial sector regulators that will remove the scope for regulatory arbitrage and improve the supervision of jointly regulated institutions such as merchant bank subsidiaries of commercial banks and the securities market activities of non-bank financial institutions regulated under the Financial Institutions Act, 1993.” (CMDMP, Section 2.2.3, p.6.)

Table 2, Legal and Regulatory Initiatives, (12-16) of the CMDMP presented 5 initiatives to promote greater coordination and cooperation among regulators, i.e.,

¹ CMDMP, Section 2.2.3, p.7

² CMDMP, Table 2, p.5

“12. Institute a program and establish a forum for high level coordination of the SEC and BB”

“13. Execute MOU between SEC and BB on the collection and sharing of supervisory information”

“14. Authorize SEC to enter MOUs with foreign regulators within parameters”

“15. Activate “Joint Inspection Team” and conduct joint inspections of jointly

“16. Develop uniform margin standards applicable to entire financial sector³

BB and BSEC achieved a milestone in terms of regulatory policy coordination when they issued carefully and mutually supportive requirements for margin loans (a First Tranche Policy Action under CMDP II). The BSEC issued its Directive (No. SEC/CMRRCD/2009-193/135, September 30, 2012) establishing a margin lending requirement of 1:0.5 for all margin loan providers as of 1 July 2014. BB issued a complementary circular that requires all margin loan providers to abide by the margin lending requirements determined by the BSEC.

2.2.1 MOU Establishing Regulatory Policy Coordination Committee

To address the need for a formal structured mechanism for regulatory policy cooperation and coordination, a comprehensive Memorandum of Understanding on Coordinated Surveillance and Supervision (MOU) among the BB, BSEC, the Insurance Development Regulatory Authority (IDRA) and the Micro-Credit Regulatory Authority (MCRA)(collectively “the agencies”), was executed on September 23, 2012. (First Tranche Policy Action No. 2 under CMDP II) It established a Regulatory Policy Coordination Committee (RPCC) supported by a robust integrated framework for interagency regulatory coordination, particularly in regard to concerns relating to contagion risks that would have systemic consequences.

The MOU establishes voluntary arrangements for coordination and cooperation between and among the agencies, consistent with the respective authorities and jurisdictions of each and is designed to deepen exchange of information and inter-agency regulatory dialogue so as to avoid unnecessary duplication of effort; reduce the risk of conflicting supervisory directives by the agencies; and enhance the potential for synergies and alignment of related supervisory initiatives of the agencies. It also clarifies arrangements for points of contact, periodic meetings, information sharing and protocols for coordination.

³ Id.

Since its creation the RPCC has held seven or eight meetings under the chairmanship of the Governor of the BB. They have reportedly been successful in bringing together senior-level representatives of financial regulatory authorities and have initiated productive discussions.

2.2.2 Opportunities for Greater Effectiveness of the RPCC

Although the MOU is a significant first step, there is an apparent need for further improvement in regulatory policy coordination and cooperation at the highest levels of the BB and BSEC. It is illustrated by a policy conflict reported in The Financial Express on July 18, 2014.⁴ It stated that the BB and BSEC had recently clashed (apparently in a very public manner) over a proposed new Finance Company Act, 2014 (FCA) that would place regulatory jurisdiction over the capital market-related subsidiaries of finance companies in the BB. The BSEC has publicly disagreed with provisions that would give the BB jurisdiction over authorization and supervision of subsidiaries of finance companies, claiming that this would conflict with its own jurisdiction in this area. Acknowledging the BSEC's right, *and indeed obligation*, to protect its "regulatory perimeter", such high-profile public displays of discord among the principal financial sector regulators often lead to public confusion, promotes regulatory arbitrage, delay the implementation of regulatory policies, and generally , undermine the effectiveness of the agencies involved.

Additional examples of interconnections that present opportunities for the RPCC to be more effective include addressing:

- The negative impact of taxation of life insurance proceeds on development of the insurance sector;
- The impact of the high interest rates paid on National Savings Certificates on bond markets and mutual funds;
- The role of banks in a market dominated by retail investors;
- Filling the void created by a lack of pension funds;
- The low acceptance of mutual funds.

The central theme of the RPCC should be to discover, understand, address and resolve regulatory policy issues that arise because of the interconnectivity of the various components of the financial sector. Its central objective should be to arrive at mutually supportive solutions that produce balanced policy responses that are supportive of the development of the financial sector as a whole.

⁴ The Financial Express, "BSEC identifies areas of discord with BB", July 18, 2014.

2.3 Promoting the Understanding of Laws and Regulations

This section looks at how the BSEC can support the development of the capital markets through its efforts to make securities laws and regulations clearer, more understandable and more broadly accessible, with the ultimate objectives of building confidence in Bangladesh's capital markets, and increasing levels of compliance.

2.3.1 Codification

In CMDMP the BSEC recognized the need for codification of Bangladesh's securities laws and regulations. It stated:

“Presently, laws and regulations governing the securities industry are widely dispersed and fragmented, making it difficult for regulated entities (and just as importantly those potentially wanting to enter the various regulated businesses) other market participants, and those evaluating Bangladesh's capital markets (e.g. potential international institutional investors) to assess/evaluate compliance with the various laws and regulations (this is especially the case with respect to rules, regulations, orders and directives). Some Initiatives are intended to address this problem.”⁵

Initiative 17 is as follows: 17. “Codify the securities laws”⁶

To simplify and enhance the clarity of the regulatory framework, the central statutes of the capital market – i.e. the Securities and Exchange Ordinance, 1969 (Ordinance); the Securities and Exchange Act, 1993, (SEC Act) and the Depositories Act, 1999 - should be consolidated into a single Act or Code (codified) and all amendments to rules and regulations should be compiled in a way that the final text is readily accessible in hard and electronic copy and on the BSEC website in Bangla and English. Codifying the key securities laws is a medium to long term project that would most likely involve a range of stakeholders including law professors and the private bar as well as the BSEC's General Counsel.⁷ Any codification would be expected to be made available in the most user friendly and, if privately published for profit, in the most commercially viable format.

2.3.2 Availability in English

Bangladesh's securities laws, regulations and notifications are now published in hard copy form and electronically on the BSEC and other websites. However, many are

⁵ CMDMP, Section 2.2.3, pp.6 and 7

⁶ Table 2, Legal and Regulatory Initiatives, p.5.

⁷ We are advised that the BSEC has already taken initiatives to codify the securities laws to make them readily available in English versions.

available only in Bangla and lack official English language translations. To make the laws and regulations more accessible in the immediate to short term, the BSEC (perhaps as a joint effort with a legal publisher), may wish to organize the laws and regulations by subject matter instead of chronologically. The CMDMP Initiative 18 states: 18." Present laws, rules, regulations and notifications in English as well as Bengali"⁸

2.3.3 Rulemaking and Regulatory Partnership

Among the goals in effective rulemaking are to solicit and encourage cooperation in formulating laws, rules and policies and by doing so, to broaden understanding of, and compliance with them. The Ordinance and SEC Act provide several means of facilitating private stakeholder Involvement, acceptance and compliance with rules through the law reform and development process. Foremost are provisions for publication and public comment on draft rules prior to their adoption. Stakeholders have availed of those means, but also assert that they would be better able to plan and provide the BSEC with a broader perspective if they could participate with the BSEC at initial stages of policy formulation.

The Ordinance contemplates the need, and offers a mechanism, for such stakeholder coordination and participation in the regulatory process. Section 27 authorizes the BSEC to constitute an Advisory Committee for the purpose of obtaining advice and assistance in carrying out its purposes. It provides that the Advisory Committee consist of persons affected by the Ordinance or with special knowledge of the subject matter as the BSEC may think fit. Such an Advisory Committee had been constituted earlier, but has not been active in recent years.

Other opportunities for encouraging private stakeholder inclusion in the regulatory process present themselves when rules are being formulated. Concerned industry and professional associations, e.g. Merchant Bankers, Asset Managers and stock exchanges or ad hoc expert committees may be consulted for suggestions or recommendations during the initial pre-drafting stages of the regulatory process that would help to adapt the rules to their operations, anticipate and overcome obstacles, and facilitate compliance with any contemplated rule, notification or directive.

Another means of opening the regulatory process to greater participation of stakeholders is through issuance of "concept" releases that solicit the public's views on securities concepts/issues that enables a securities regulator to evaluate the need for and focus of future rulemaking.

Recommendation 1: To encourage increased private stakeholder participation in, understanding of, and compliance with BSEC rules and regulatory policies, to increase

⁸ Table 2, Legal and Regulatory Initiatives, p.5.

transparency and to encourage market participants to take greater ownership of BSEC rules and policies, the BSEC may wish to consider:

- Reestablishing its Advisory Committee including a formal structure, scheduled meetings and agendas to encourage and solicit wide, but focused, discussions of regulatory policy issues;
- Inviting representatives of the securities industry to participate in discussions of or comment on proposed rules in the pre-publication stage; and
- From time to time, as the need arises, publishing and inviting comment on concept releases.

In this period of continuing development and reform of market institutions, as the boards of directors of the newly demutualized exchanges gradually get their footing, as market infrastructure is strengthened and new products are offered, the need for coordination and transparency in the rulemaking process is paramount. To bolster the BSEC's rule-making process, the BSEC may wish to consider adopting a process that would ensure that:

- The need for a regulation has been identified through regular review of the financial sector to identify emerging issues (i.e. new products, services, technologies, needs) that may require regulation;
- Before a regulation is drafted, BSEC has explored alternative policy tools (Why is regulation needed? Can the policy objective be achieved through other policy tools?);
- The regulation is based on, and includes, a formulated regulatory policy statement that assesses the need and defines its policy objective;
- The regulation is based on an impact assessment (Is there a clear public interest? How many people does it affect? Cost-benefit analysis);
- The BSEC has the resources required to implement it;
- The regulation is based on a formalized approach to drafting;
- The regulation will be subject to a formalized approach to stakeholder consultation;
- The regulation is part of a rolling medium term (e.g. 3-5yr) regulatory agenda.

In addition to laws, rules and notifications, the body of the legal framework within which participants must function can include BSEC directives and unrecorded oral instructions in addition to written laws, rules notifications and guidance. The process of providing directives and oral instructions that individual entities are required to follow can lead to inconsistent and arbitrary regulatory policies. On the other hand, publication and compilation of individual rulings can help to build a more coherent, consistent, fairer

and more transparent body of laws and regulations that would help to inspire confidence in the BSEC and wider application of consistent principles throughout the market.

Recommendation 2: To provide a more consistent and transparent body of law, the BSEC may wish to consider a policy of providing written guidance, instead of oral instructions, to market participants and of publishing such guidance including the factual context in which it was given, and of compiling and periodically publishing such guidance.

3 Authorization of Participants and Practices

Given the preponderance of individual, relatively unsophisticated investors in the capital markets (indicating a low capacity to gather and analyze information), and the general lack of transparency (indicating a high cost of obtaining the required information to determine the fitness of market intermediaries), one of the most important functions of the BSEC is its authorization responsibility. It is of the highest importance that the BSEC refrain from licensing any intermediary until and unless it is positively convinced that the applicant is in all respects suitable for the business proposed. i.e. that it is “fit and proper” (key criteria are honesty, competence) and that it is adequately capitalized.

3.1 Certification of Professionals

The BSEC in CMDMP recognized that the challenges facing it with respect to its role in authorizing market participants ranged from “a lack of internal capacity to oversee the stock exchanges to the lack of a complete, comprehensive and credible system of assuring the professional integrity, knowledge and proficiency of market professionals and holding them accountable for their actions.”⁹

Our recommendations with respect to certification are one leg of a proposed “three legged stool” approach to raising standards in the market. The other two legs are strengthening intermediaries’ financial condition and strengthening business and market conduct standards. These are discussed below at Section 4.5 Strengthening Intermediaries –A “Three Legged Stool” Approach. Because, like a three legged stool, for them to support the development of the industry, they must function together, they are discussed together at Section 4.5, below.

Guidance on Preparation of IPO’s and Due Diligence

The BSEC’s recently amended Public Issue Rules, (2006) (PIR) are a comprehensive set of instructions for the issuance of securities. PIR includes detailed requirements relating to

⁹ CMDMP, Section 2.2.4, p.7.

advertisements; pricing; timeliness and accuracy of prospectus information; enumerated disclosures on an issuer's business and operations; specific disclosure requirements augmented by general disclosure requirements; issuer transactions with control persons; subsidiary/holding companies; completeness; approval, rejection and review; accuracy and proper responsibility for information content; prohibition of false statements; prohibition of fraudulent acts; officer, director, manager responsibility for company acts; joint and several liabilities for damages in civil suits and personal acceptance of full responsibility.

In addition to certifications of financial statements by auditors, they also require a Due Diligence Certificate of Manager to the Issue, signed by the Merchant Bank and an Underwriter's Due Diligence Certificate. The BSEC also has ongoing disclosure requirements for listed securities and BSEC power to require annual and other reports and additional powers to require reports and regulate proxy solicitation.

The explicit and detailed requirements of the PIR have not been well-observed. Issuers frequently file incomplete or inaccurate applications for consent to an IPO. As a result, the IPO approval process that affects the flow of securities into the market and is critical to maintaining the quality and reliability of the information in the market has not functioned efficiently.

To address this weakness, we advocated in CMDP II that the BSEC issue user friendly guidance that clearly communicates and provides guidance to issuers on meeting the SEC's issuance requirements.¹⁰ The BSEC adopted that recommendation in CMDMP Initiative 23 "Publish guidance/guidelines for IPO Applications".¹¹ CMDMP concluded that the process of issuance of securities by issuers

"has tended to be excessively slow in Bangladesh and it has often been pointed out as a factor contributing to the stock market bubble, as it had the effect of constraining the supply of securities in the face of strong demand stimulated by excess liquidity and lax margin rules. The primary factor contributing to this delay appears to be the lack of adherence of submissions to the (B)SEC's requirements. Initiative 28(23) is intended to provide a mechanism to clearly communicate and provide guidance to the issuer community on the SEC's requirements with respect to the issuance of securities, and will enhance transparency in this regard."¹²

We envision that guidance would describe obstacles to faster processing commonly encountered in the review process (e.g., lack of compliance with IAS and ISA,

¹⁰ One example of related guidance may be found on the SEBI Website (www.sebi.gov.in/publicissudefaq.html). It is an attractive four page easily understood Question and Answer primer.

¹¹ Table 5, p. 5.

¹² CMDMP, Section 2.2.4, p.7.

incomplete or lack of appropriate documentation, failure to disclose related parties, etc.) and offer concrete suggestions on how to overcome them, including a check list of do's and don'ts for issuers and issue managers.

The BSEC has also recently undertaken two separate projects related to the process of IPO issuance: one, now undergoing a pilot trial, would reduce the IPO issuance process to 15 days; the second would review the entire IPO issuance process. We endorse the BSEC's initiatives in reviewing the IPO issuance process and undertaking the pilot trial. If proves effective, we would recommend the broad application of the process to all IPO issuances.

With respect to the BSEC's review of the BSEC's IPO issuance process, we note that merchant bankers have noted inconsistencies in, and lack of understanding of, how the role of issue manager is discharged. The Bangladesh Merchant Bankers Association (BMBA) has suggested that the BSEC issue guidance on the requirements of due diligence that provide a simple step by step procedural manual or checklist for issue managers to perform due diligence. Issuing such guidance would be a relatively simple, but significant, step that could help make the IPO review process more efficient. Providing the required guidance may also present an opportunity for enhancing a regulatory partnership with the BMBA. The BSEC might wish to invite the BMBA to collaborate or contribute to drafting such guidance or to submit a proposed draft or outline of what such guidance might cover.

Recommendation 3: To improve the speed of processing IPO applications and the quality of due diligence associated with the IPO process, the BSEC may wish to consider publishing guidance for issuers that informs them of the steps they can take to ensure that their IPO applications are processed expeditiously and issue managers provide them with a simple and complete procedural manual or checklist to ensure that due diligence is performed at uniform high levels. This guidance should include descriptions of the five most common obstacles to the expeditious processing of IPO applications and provide pointers on how these bottlenecks can be avoided.

4 Monitoring and Investigating Market Participants

Monitoring is the sustained and routine surveillance of participants in the securities market. Monitoring includes both activities at the BSEC reviewing reports and documents filed with the BSEC and on site activities inspecting operations and the maintenance of regulated entities' systems and procedures and/or books and records in the ordinary course of a securities regulator's supervision of the market. Its goals are to ensure that the protections required under the laws, rules and regulations are in place and are operating well.

As applied in Bangladesh, monitoring and investigating market participants includes surveillance of trading, oversight of the operation and protections provided by the stock exchanges, inspections of individual broker dealers, merchant bankers and other intermediaries and ensuring that the standards in place are sufficient to provide adequate protections to investors and professional market participants.

4.1 Market Surveillance

The BSEC's Instant Watch Surveillance System (IWSS) has provided the BSEC an effective means of maintaining close surveillance of trading. However, some system limitations have been observed by the BSEC Surveillance Department. IWSS does not generate broker-wise alerts; does not have any option to show trade/market related statistics; and because an individual can open multiple beneficial owner accounts, the system may not detect market manipulation, insider trading and other market abuses through such accounts. To address evasions through multiple accounts, the BSEC may wish to consider requiring all account holders to use a nationally issued personal identification number or requiring only one account per person at the CDBL with a single identification number for the beneficial owner of the account.

4.2 Stock Exchange Oversight

Our assessment under CMDP II revealed weaknesses in the exchanges' capacity to reliably discharge their duties. These related, among other things, to inadequate surveillance; lack of transparency disciplining members; continued listing of non-traded securities; reducing systemic risk; and lack of effective participation of non-affiliated board members. As mutual-owned entities, the Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE), were owned and operated by their members (brokers). To trade on either of the exchanges one had to have an ownership interest in it. The boards of the exchanges were controlled by their broker members.

Over the ensuing 2 years, with the assistance of TA from of other ADB Projects, the DSE and CSE have demutualized. With enactment of the Exchange Demutualization Act, 2013, on April 29, 2013 (effective May 2, 2013), the primary goal of demutualization, to change the governance structure of the exchanges, has been achieved. The new board of each exchange consists of 13 members, 7 of whom are independent, 5 are associated with TREC holders and one seat is reserved for a strategic investor. The General Manager is a non-voting member. Each board has 5 committees: Nominating and Remuneration; Regulatory Affairs; Audit and Risk Management; Appeals; and Conflict Mitigation.

Anticipating demutualization, we cautioned that demutualized exchanges, because they are operated for profit, may place less emphasis on the value of a full self-regulatory program and focus more on maximizing value for its shareholders. We

cautioned that changes in priorities and shifting incentives could result in conflicts of interest that could weaken the exchanges self-regulatory role. Citing a World Bank Study¹³ our Final Report for CMDP II identified the types of conflicts that must be managed¹⁴. We also cited a subsequent World Bank study¹⁵ that identified conditions that would be necessary for the exchanges to fulfill their self-regulatory roles. Many of the conditions cited have been and may still be lacking or poorly developed at the stock exchanges. Among the conditions cited were:

- A tradition of reasonably effective self-regulation;
- A securities regulator that can provide effective oversight that minimizes conflicts of interest;
- Markets large enough to support a self-regulatory program; and
- Exchanges that are willing and able to fulfill their regulatory functions or that would support the creation of an independent SRO to carry out those functions.

If the exchanges in Bangladesh follow the same pattern observed by the above cited studies, many of their self-regulatory functions will need to be assumed by the BSEC. In view of the shifting incentive structures introduced by demutualization of the exchanges and to ensure that the new structures do not adversely impact investor protections, we recommended that the stock exchanges be required to prepare assessments of the investor protections they provide and submit them to the BSEC for review and evaluation.

An essential part of the transition to demutualized exchanges has been the adoption by them of structures that separate business and regulatory activities and address the conflicts arising under their new ownership structures. Critically important is their ability to identify and manage potential conflicts of interest between commercial and regulatory functions and train and educate employees with respect to conflict management. As far as we are aware, the comprehensive assessments by the exchanges envisioned by CMDP II have not been requested, much less performed or submitted. They should provide a top down picture of:

- How well the exchanges new Boards and executives understand the conflicts presented by their business and regulatory activities;
- The policies they have put in place to control such conflicts and improve regulatory protections; and

¹³ *'Conflicts of Interest in Self-Regulation: Can Demutualized Exchanges Successfully Manage Them?'* John W. Carson, World Bank Policy Research Working Paper 3183, December 2003. (Carson)

¹⁴ For a full discussion see the CMDP II Final Report.

¹⁵ *"Self-Regulation in Securities Markets,"* John Carson, Managing Director of Compliax Consulting, Inc., August 2010.

- The staffing, budget, capacity and results achieved by each exchange, and each of its component departments.

Completion of these assessments is a critical first step in providing adequate investor protection under the exchange's dematerialized structures. The BSEC in its CMDMP recognized the importance of such assessments and in response adopted Initiative 26 which states, "Submit plans to SEC for protecting investors given new incentive structure created by demutualization".¹⁶ It also focused on the need to strengthen its oversight of the stock exchanges, and in particular to inspect them. It stated,

"The SEC shall begin conducting comprehensive examinations of the two exchanges in Bangladesh for the stock exchanges to develop and submit to the SEC their plans for protecting investors in view of their new governance and incentive structures adopted as a result of their demutualization."¹⁷

To ensure that the BSEC continues strengthen and exercise its increased responsibilities to oversee the demutualized exchanges and the Central Depository of Bangladesh, Ltd. (CDBL), we are recommending a two step process that should permit the BSEC and the exchanges to work together for the protection of investors that centers on the conflicts that can arise under demutualized exchange structures.

Recommendation 4: As an initial step, the BSEC may wish to consider requesting each exchange to complete a self-assessment of the investor protections it provides that at a minimum requires an evaluation of:

- How well the exchanges new Boards and executives understand the conflicts presented by their business and regulatory activities;
- The policies they have put in place to control such conflicts and improve regulatory protections; and
- The staffing, budget, capacity and results achieved by each exchange, and each of its component departments.

Based upon its evaluation of the exchanges' self-assessments, as a second step, the BSEC may wish to conduct inspections of the exchanges and the CDBL.

4.3 Building Capacity

To enhance the capacity of the Supervision and Regulation of Markets and Issuer Companies Department (SRMIC), the BSEC department responsible for oversight of

¹⁶ CMDMP, Table 2, p.5

¹⁷ CMDMP, Section 2.2.7, p.9.

stock exchanges, under CMDP II we recommended a detailed and focused program¹⁸ that would significantly improve its capability and effective control over the exchanges. We also recommended that the Department be expanded and receive intensive training in stock exchange oversight (in addition to the training received by the Surveillance Department on its IWSS) to ensure that the BSEC staff is capable of continuous oversight of the exchanges, including the ability to conduct an effective exchange inspection. The SRMIC has increased from 5 to 7 persons and a detailed program of capacity building has been carried out by another ADB Project, TA-8228 BAN, which provided training to the SRMIC and manuals for oversight of exchanges and the central depository. The BSEC has designated a multi-departmental team to carry out inspections of the exchanges and the central depository. In accordance with Recommendation 5, above, the BSEC may wish to consider conducting those inspections a high priority.

4.4 Inspections of Market Intermediaries

The BSEC, in CMDMP acknowledged that

“On-site inspection of intermediaries has suffered as a result of the SEC’s resource constraints. As a matter of necessity, there has been a lack of emphasis on the inspection of non-broker intermediaries. Once the SEC is staffed at higher levels it will increase its on-site inspection activities, especially with respect to non-broker market participants (e.g. merchant banks, mutual funds, issue managers, etc.).¹⁹”

CMDP2MP envisioned that as BSEC’s resource constraints are lifted, it would increase and diversify its inspections to include those of non-broker intermediaries.

Table 1 - below indicates the increases and diversity in the BSEC’s Inspection Program over the past three fiscal years.

Table 1 - BSEC Inspections Conducted FYs 2012 - 14

	2012	2013	2014
Total Number of Inspections - all types of institutions/ intermediaries	87	105	101
Number Regular inspections	37	103	101

¹⁸ Included were a thorough review of: the SEC’s authority to oversee the exchanges; exchange rules and the proper functioning of each exchange department (including adequacy of staffing to meet requirements); operations of trading and surveillance systems; effectiveness of listing rules; investor protection funds and other means of minimizing systemic risk; strengthening exchange clearance and settlement procedures; and proper exchange governance structures (including the role of its independent directors). It called for developing an SEC manual for exchange oversight and inspections and procedures for off-site reviews of exchange operations, with special attention devoted to clearly delineating regulatory roles and responsibilities and a strong focus on possible conflicts of interest that can arise in the operation of demutualized exchanges.

¹⁹ CMDMP, Section 2.2.7, p.9

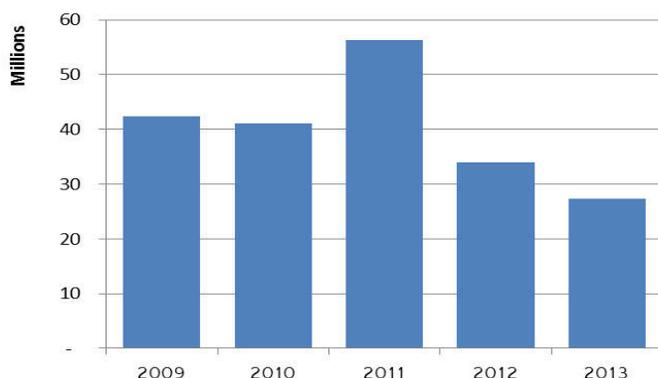
	2012	2013	2014
Number special (for cause) inspections	4	2	-
Number of Broker-Dealers inspected	31	105	82
Number of Merchant Banks inspected	2	-	14
Number of Asset management Companies inspected	-	-	5

As shown in the Table, total annual inspections increased from 87 in fiscal year (FY) 2012 to a maximum of 105 in FY 2013, and slightly declined to 101 in FY 2014. The increase of 14 inspections from FYs 2012 to 2014 represents a 16 percent increase. Moreover, in 2014, the BSEC increased the diversity of its inspections by inspecting 14 Merchant Banks and 5 Asset Management Companies, representing nearly 20 percent of its inspection program. In addition to its inspections focusing on brokers who account for a large percentage of market volume, the BSEC has introduced a lottery system that focuses on small broker dealers to ensure that they are aware that they will be subject to inspection and must be prepared to meet required standards. Its current annual rate of inspections of broker dealers represents an inspection cycle of 3 years for broker dealers.

4.5 Strengthening Intermediaries – A “Three Legged Stool” Approach

Market intermediaries constitute one of the foundational “building blocks” of the capital markets. However, broker-dealers and merchant banks were dealt a hard blow as a result of the 2010/11 stock market crisis and many remain in a weakened financial state that constrains them from positively contributing to the growth and development of the capital markets.

Figure 1 – Declining Market Turnover



Source: CDBL Annual Reports, 2009-2013

There are over 230 licensed broker dealers in Bangladesh. They range from large multi-service sophisticated firms to small family owned firms with few employees. Although many brokers are capable, well-trained, well-resourced and maintain high standards, not all are able to sustain a high level of performance and meet international standards of best practice. Two factors severely constrain the ability of many of the

broker dealers to operate profitably while maintaining high standards: the declining level of activity; and the concentration of this activity in fewer firms.

As shown in **Figure 1**, the number of trades declined by 39 percent in 2012 (from 56.27 to 33.95 million) and by a further 19 percent (to 27.26 million) in 2013. The level of revenue generated by these volumes is not sufficient for all 230+ firms to sustainably maintain profitability while meeting higher and better-enforced standards. Furthermore, it appears that the bulk of activity is concentrated in the top 80 -120 firms.²⁰ It may be necessary to strengthen this “building block” because, just as a durable building cannot be built on a weak foundation, strong capital markets cannot be (re)built on a weak intermediary industry.

The solution we have been developing in consultation with the BSEC and other stakeholders has three elements, all of which will need to be implemented - more-or-less simultaneously - and none of which can be omitted. We liken it to a 3-legged stool that can stand only if all three legs are present and that becomes dysfunctional if one or more of the legs are removed. Thus, for ease of reference (and as an *aide-mémoire*), we have labeled it the “3-Legged Stool Approach” to strengthening the intermediaries.

4.5.1 Financial Strengthening – The First Leg

The first element of the approach (leg of the stool) would include measures to strengthen the intermediaries’ financial condition (i.e. broker-dealers and merchant banks). This element would have two sub-components (measures), namely:

- The adoption of a capital adequacy standard that is more directly and closely related to the levels and types of risks being born by the intermediary; and
- The recognition and resolution of capital deficiencies stemming from the 2010/11 stock market crisis.

However, the matter of unrecognized losses on margin accounts should be addressed before a risk based standard for minimum capital is adopted. Otherwise, it may not be possible to effectively enforce the risk-based capital standard.

4.5.1.1 Margin Lending-Related Losses

We are informed that one of the most significant contributors to the financial losses suffered by broker-dealers and merchant banks in the wake of the 2010/11 crisis has been those stemming from their margin lending activities. For many institutions, these losses have continued to worsen, as the affected loans (“infected portfolios”) may not have been written off, and, in the meantime, accrued unpaid interest and a deteriorating market have added to the initial losses. We are advised that, in many

²⁰ The Director of the BSEC’s SRI Department has estimated that 120 firms account for 80-90 percent of all transactions on Bangladesh’s stock exchanges.

instances, the full magnitude of these losses may not have been recognized in the intermediaries' financial statements.

Some stakeholders have suggested that for some lenders the trouble started when the stock market reversed course and experienced sharp declines from its peaks in late 2010 and early 2011. It has been suggested that certain of those lenders may have voluntarily refrained from issuing "margin calls"²¹ (especially as a "courtesy" to their "preferred" clients) that would have topped-up borrowers' accounts with cash to cover losses or triggered sales of the underlying securities. This then resulted in leverage ratios that far exceeded the already- liberal limits (some have suggested these were *too liberal*).

Others suggest that the lenders' efforts to enforce margin calls (a perfectly legitimate, legal²² and standard practice worldwide) to secure cash deposits were thwarted by the statements of government officials publicly denouncing the practice of "trigger sales".²³ This, they say, reinforced a "culture of non-compliance" among borrowers, which, combined with the public pressure to avoid sales in the face of a sharply declining market, left lenders with few alternatives to "absorbing" the losses with the hope that, as the market eventually recovered, they could recoup some, or all, of these "paper" losses. However, in most cases the market has not sufficiently recovered to recoup these losses.

The BSEC's response has been to provide regulatory forbearance/relief by temporarily suspending certain provisions of the Margin Rules, 1999 for Broker-Dealers.²⁴ The current extension expires June 30, 2015.²⁵ While an investigation into the proximate causes of such losses is beyond the scope of this assignment, anecdotal evidence suggests that there is likely to have been more than one contributing factor, and that the mix of factors differs by institution.

²¹ Section 3(5) of the Margin Rules, 1999, requires that "Whenever the equity in a client's margin account falls below 150% of the debit balance, the member shall request the client to provide additional margin to bring the equity to not less than 150%. Such additional margin must be satisfied by deposit of cash or marginable securities within three days from date of notice. The member shall not permit any new transactions in the margin account unless the resulting equity in the account would be not less than 150% of the debit balance." In sum, if the value of the equity in a client's margin account fell below 150 percent of the amount owed, the broker was obliged to request the client to provide cash or marginable securities to bring his margin account value up to 150 percent.

²² Id.

²³ *No forced share sale - Muhith urges merchant banks to stop it when stock market dips* The finance minister has once again asked merchant banks to stop forced sale of shares in the volatile stock market. 'When the market goes down, investors have to count losses. In this situation, if the merchant banks go for forced sales, investors will have to incur even greater losses, and this is unfair,' said AMA Muhith at a press briefing in the capital yesterday. ...Last week, the minister told reporters that the government would formulate a set of guidelines to control such sales, also known as trigger sales." The Daily Star, Saturday, February 11, 2011.

²³ Section 3(5) is the section that requires providers of margin loans to make margin calls when the minimum equity threshold is breached in margin loan accounts.

²⁴ We are informed, however, that BSEC has not formalized parallel forbearance for Merchant Banks. (Merchant Banker and Portfolio Manager Rules, 1996)

²⁵ Order No. SEC/CMRRCD/2009-193/165 (January 6,2015)

Regardless of the factors contributing to these losses, the industry remains in a weakened financial state because of them. We would suggest that the situation may need to be addressed in a *more systematic and comprehensive manner* than the temporary forbearance approach presently adopted by the BSEC. Our recommendation is that the BSEC may wish to consider dealing with these losses in conjunction with a broader initiative to enhance the financial strength of the brokerage and merchant bank industries as a whole, as it would be difficult to build a strong market on a weak foundation. Furthermore, the “market overhang” resulting from it is likely to continue suppressing the stock market until the situation is resolved decisively.²⁶

Assessing the level of Capital Impairment - As a first step to developing a comprehensive approach to strengthening the financial condition of the industry, the BSEC may wish to consider conducting a study to determine the scope (i.e. the number of institutions affected) and magnitude (the amount per affected institution) of the losses (i.e. level of industry-wide capital impairment) associated with the events of 2010/11.

Margin Loan Loss Resolution and Capital Restoration Plan - Once the level and nature of the impairment is determined, it would be our suggestion that the BSEC, in consultation and collaboration with the industry, the MOF, Bangladesh Bank, NBR, and ICAB, devise a comprehensive, mutually acceptable solution that would decisively resolve the matter in a way that would allow the industry to move forward without the “baggage” that has been weighing it down in the last 3 years. The details of the resolution plan will be determined, in part, by the findings of the BSEC study, and subject to negotiation among the relevant stakeholders, but framers of the plan should strive, to the extent possible, to include in it the removal of the “infected assets” from the affected entities’ balance sheets, while avoiding the “moral hazard” problem.²⁷

This may include the following elements, among others:

- Recognition of the “paper” losses by the concerned entities;
- Closing out affected clients’ accounts;
- A Capital Restoration Plan that would replenish the affected intermediaries’ capital to the levels that would be required under a newly-adopted risk-based standard.

²⁶ “Market overhang” is a phenomenon whereby investors put off buying shares of a particular stock, group of stocks, or the entire market based on a widely held belief that a large volume of sales are awaiting execution once certain conditions are met – e.g. a target price is achieved. Investors are hesitant to buy until they are reasonably certain that the large volume of pending sales is absorbed by the market. Depending on overall market liquidity, a market overhang can last for weeks, months or even years.

²⁷ An example can be drawn from the United States. Following its Savings & Loan (S & L) crisis in the early 1980s, the U.S. allowed the S&L industry which was experiencing severe maturity mismatches of its balance sheets to securitize and sell said loans and amortize resulting losses over a long period to minimize their severity.

4.5.1.2 A Risk Based Capital Standard

The BSEC has been working (both on its own, and through the assistance provided under a concurrent ADB technical assistance project) to develop a capital standard that is more “risk-aware” than the current one. Our understanding, from discussions with BSEC and the ADB consultant, is that two standards are being considered – one that is based on the “Net Capital Rule” used in a number of countries (e.g. Singapore, Hong Kong, Australia, the US), and another that is based on the Basle Committee’s approach. While the recommendation of a specific model is beyond the scope of our assignment, our suggestion may be that the model adopted meet two “tests” – the first is that it can be easily understood, implemented, monitored and enforced; and the second is that it appropriately consider (and reflect) ground realities.²⁸

4.5.2 Strengthening Business and Market Conduct Standards – The Second Leg

Business and market conduct standards are those to which all market intermediaries should be required to adhere in dealing with clients and their assets. Among other matters, they set out the responsibilities intermediaries must have toward their customers, require that intermediaries give priority to their customers’ interests over their own, and the manner in which customers’ assets should be held and protected. They address such matters as accountability for compliance, customer due diligence, the types and frequency of information to be provided to customers, procedures for managing discretionary accounts, ethical business practices, etc.

While BSEC regulations appear to adequately and appropriately address most of the central provisions typically found in business and market conduct regulations, many of the stakeholders we have encountered in our consultations have lamented the inadequacies of intermediaries in this area, indicating that these inadequacies may be a result of the lack/absence of appropriate enforcement measures. In CMDMP, the BSEC pointed out:

“much needs to be done in terms of basic protections for investor when dealing with brokers. They relate to the right to periodic customer account statements; know-your-customer (KYC) suitability protections; anti-money laundering protections; internal systems and controls that are designed to ensure that a firm is properly managed and customers’ interests are protected; supervisory responsibility rules that hold the officers and managers liable for failure to supervise and strengthened risk adjusted capital adequacy rules tailored to the level and type of risks to which a firm is exposed.”²⁹

²⁸ In particular, that the situation in Bangladesh may favor the adoption of a liquidity-driven model over a solvency-driven one.

²⁹ CMDMP, Section 2.2.7, p.10

We suggest that the BSEC conduct a comprehensive review and assessment of its business and market conduct regulations to evaluate whether or not they are adequate and adhere to international standards of best practice. We also suggest that it review its examination protocols to ensure that business and market conduct is an important focus of these examinations. BSEC may also wish to review its policies and procedures to ensure that customer complaints receive proper attention – at the level of the intermediary, the stock exchanges, and in the context of BSEC's own handling of investor complaints. If these reviews and assessments reveal significant divergence from best international practice, then the BSEC may want to consider amending the regulations, increasing the number of unscheduled examinations/ inspections (especially for those intermediaries generating above-trend customer complaints) and/or conducting an awareness-raising campaign for the intermediaries and their customers concerning the responsibilities and obligations intermediaries have toward their clients.

4.5.3 Professional Certification – The Third Leg

The BSEC in CMDMP underscores the need for certification of professional market participants. It states:

“Consumers should be able to rely on the SEC's certification and authorization process to “weed out” bad actors (i.e. those who are poorly trained, ill-informed, unprofessional and/or unethical). SEC intends to enhance the professionalism, integrity and accountability of the brokerage industry. While professionals in the brokerage industry are already required to obtain training, they are not required to demonstrate their proficiency and knowledge, and they are not held accountable in the event they (or their subordinates) fail to adhere to professional standards. We recognize that this is a standard international best practice, and that its adoption in Bangladesh will raise the standards of our capital markets.”³⁰

To ensure a high quality of professionalism throughout the industry, key personnel of intermediaries should be certified under a program that ensures they possess and maintain a minimum level of knowledge and skills, and adequate information concerning their duties and responsibilities toward their customers.

The BSEC does not currently require certification of licensed intermediaries.³¹ Another ADB Project (TA-8228 BAN) has developed a draft curriculum and draft rule that would

³⁰ CMDMP, Section 2.2.4, p.7

³¹ We are advised that the BSEC provides certificates to Authorized Representatives of stock brokers/stock dealers of DSE and CSE. Before issuing such certificates, it arranges training programs for such applicants in collaboration with the DSE and CSE, but no examination is required to receive such certification.

require professional certification for key employees of intermediaries. That rule is under consideration by the BSEC, and we suggest that it be adopted at the earliest. In conjunction with the rule, it will be necessary to develop standard examinations that all professionals must take and pass before being licensed. The examinations should be supported by a standardized curriculum and study materials that meet high standards. Any professional institution should be allowed to provide any necessary training and applicants should have the option of studying the materials on their own. Applicants may enroll in any such course that they see fit. However, all should have to take and pass the same examination for their particular specialty.

As capital markets products and services evolve and new and more complex ones are introduced, market professionals will need to regularly update their skills and knowledge to keep up with these innovations and changes. Because a blanket exemption from examinations for experienced persons would inhibit the upgrading of skills and knowledge, we would advise against such exemptions (e.g. for persons with a certain level of experience in the industry) to the certification requirement.

In order to maintain currency in their knowledge and skills, we also suggest that all certified market professionals be required to undergo a minimum of number of hours (e.g. 20 hours or such number BSEC finds more suitable) of continuing education per year as part of market professionals' requirement for maintaining their licenses.³²

Recommendation 5: To better understand the magnitude of the "Rule 3(5) problem" – i.e. its potential impact on intermediaries' balance sheets –the BSEC may wish to consider undertaking a study to quantify the extent of any losses that would result from marking the affected securities to market and "closing out" the accounts of affected clients. This would enable the BSEC, with government concurrence, to devise a plan for addressing deficits stemming from the "Section 3(5) problem". A requirement to conduct such an "impact study" may be considered by the ADB as a First Tranche Policy Action (T1PA) for the CMDP III Policy Loan.

The adoption and execution of such a plan (i.e. "Section 3(5) Capital Impairment Resolution Plan") would avoid the risk of further impairment due to continuing market deterioration.

Recommendation 6: Depending on the magnitude of the impairment, a Second Tranche Policy Action may be the development and adoption of a concrete Capital Impairment Resolution Plan that would squarely address the issue of capital impairment.

³² Furthermore, the levels of activity around which the markets appear to have stabilized are likely to be sustained for the foreseeable future, and may not be sufficient enough to sustain the large number of authorized intermediaries currently comprising the industry. This process of strengthening, may serve to clarify the seriousness of intentions of current intermediaries.

Recommendation 7: After the BSEC has determined the magnitude of the Rule 3(5) problem and adopted a Capital Impairment Resolution Plan, it may wish to consider issuing a new risk based capital (RBC) rule based on the work of ADB TA-8228 BAN (Enhancing Efficiency of the Capital Market), followed by developing and adopting a plan for the recapitalization of capital deficient intermediaries within a reasonable time frame.

ADB may consider adopting the first part of this recommendation (BSEC's adoption of an RBC rule) as a First Tranche Policy Action (T1PA), and adopting the second part (BSEC's adoption of a recapitalization plan) as a Second Tranche Policy Action (T2PA).

Recommendation 8: To establish a high level of professionalism of all intermediaries, the BSEC may wish to consider adopting a rule to 1) require professional certification for key employees of intermediaries and 2) require licensed professionals to maintain currency in their knowledge and skills by completing a minimum number of hours (e.g. 20 hours or such number BSEC finds more suitable) of continuing education per year as a condition of maintaining their licenses. In conjunction with the rule, it will be necessary to develop standard examinations that all professionals must take and pass before being licensed.

5 Enforcing Laws and Regulations

A high level of compliance with laws, rules (and best practices) throughout the market is a necessary prerequisite to achieving the conditions that characterize a well – functioning securities market (i.e. little or no risk of loss from dishonesty; ready identification of the level of risk associated with investment; low systemic risk; and efficient allocation of resources). The effectiveness of a securities regulator's enforcement program, more than any other essential function determines the credibility of a securities market regulator and consequently the development of the capital markets. To achieve a high level of compliance it is essential that the BSEC maintain an effective enforcement program including a meaningful deterrent. The BSEC has committed to doing that in CMDMP. It stated:

“We recognize that the principal challenge of the supervisory regime is related to the enforcement of the laws and regulations that are already on the books. The present situation can be characterized as one of “under-enforcement”. This is the result of two principal factors: First, weaknesses at the SEC have prevented effective supervision of the markets and intermediaries and have hampered effective enforcement actions. A decade-long “brain drain” coupled with the inability to recruit and train new talent has sapped the SEC's ability to effectively regulate the securities industry.

Second, the prevailing court system, in terms of time required to dispose the cases, has allowed offenders to tie up cases for lengthy periods – sometimes years, or even decades – frustrating the SEC's enforcement efforts. We are, therefore, committed to rebuilding the SEC's capacity to supervise the capital markets and to finding a solution to the challenge posed by the lengthy legal process."³³

At March 31, 2014, the BSEC reported 461 cases outstanding. However, it appears that almost 47 percent (215) were quasi-judicial cases for collection of penalties under the Public Demand Recovery Act, 1913, (PDRA). Setting those cases aside temporarily leaves 246 criminal and civil cases. However, as shown in **Table 2**, below, (which excludes cases filed under the PDRA) there were only a total of 47 cases pending at year end 2014 (15 civil and 32 criminal cases). The explanation for the large disparity is that of the remaining 246 cases, 199 (246-47=199) were writs or other appellate proceedings spawned by the original 47 pending cases.

The large number of pending cases attributable to writs and appellate proceedings suggests that the BSEC may wish to review its representation in such proceedings. The BSEC engages private law firms to represent it in such appellate and writ cases. The criteria for the selection of such private law firms is only that they have been in practice for at least 10 years.³⁴ The BSEC may wish to re-evaluate its criteria to consider including securities law expertise and a successful record in defending appeals and writs in selecting firms to represent it in such matters.

Table 2 – Age of BSEC Cases Pending at end of FY 2014

Type of case	No. Pending at end FY 14	No. Less than 1 year old	No. 1 to 2 years old	No. 2 to 3 years old	No. 3 to 4 years old	No. 4 to 5 years old	No 5 years or older
Civil	15		02			04	09
Criminal	32		03			02	27
Cumulative	47						36

Source: BSEC Law Division

5.1 Cases Brought Under the Public Demand Recovery Act

Under the Ordinance the General Certificate Court which hears cases under the PDRA has jurisdiction over collection of fines by the BSEC.³⁵ Section 14 of the Ordinance requires the BSEC to recover short swing profits under the PDRA and the draft Financial

³³ CMDMP, Section 2.2, p.4

³⁴ Source: BSEC Law Department.

³⁵ The Ordinance Section 22 (2) provides for collection of fines as an arrear of land revenues for (a) refusal or failure to furnish any document, paper or information required to be furnished by or under the Ordinance; (b) to comply with any order or direction of the BSEC made or issued under the Ordinance; or (c) for contravening or otherwise failing to comply with the provisions of the Ordinance. Section 14 of the Ordinance also requires the BSEC to bring cases to recover short swing profits under the PDRA and Section 49A of the draft Financial Reporting Act would require the collection of Administrative fines under the PDRA.

Reporting Act, Section 49 (2), would require the Financial Reporting Council to recover administrative fines pursuant to the PDRA. However, as shown in Table 3 below, the PDRA has not proven an effective tool for recovery of fines. Table 2 traces the results of cases filed under the PDA over the BSEC's past 5 fiscal years (2009-2014). In short, it reveals that many cases are not heard because of failure of service or writs contesting the Court's jurisdiction. Recovery of fines sought by the BSEC is an abysmal 0.5 percent.

Table 3 – Cases Filed Under PDRA

	2009	2010	2011	2012	2013	2014	Cumulative Totals BDT (in Millions)	Cumulative Totals USD (in Millions)*
No. of cases filed	37	48	09	02	14	30		
Total demanded BDT (Mil)	160.14	309.83	78.76	3.11	35.18	813.56	1,400.58	18.09
Total collected BDT (Mil)	1.20	3.10	1.70	----	.50	.60	7.10	.09
Total outstanding BDT (Mil)	158.94	306.73	77.06	3.11	34.68	812.96	1,393.48	18.00
No of cases in which full amount collected			1		1	1		
Reasons amounts outstanding	Proceedings of most of the Certificate Cases are stayed by the order of the Higher Court.							
Failure to effect service on Defendant	Many of the certificate debtors are not found because they are absconding or frequently changing their address. Certificate Debtors sometimes avoid receiving the Summons.							
Writ(s) challenging BSEC jurisdiction	24	26	08	27	19	14		
Writ(s) challenging natural justice	--	--	--	--	--	--		
Case not heard	24	26	08	15	17	14		
No. resulted in issuer report	24	42	13	02	10	34		

Source: BSEC Law Division

*Bangladesh Bank Exchange Rate as on 07.09.2014 (1 USD = 77.40 BDT)

As shown in Table 3, over the BSEC's most recent 5 year period it filed 140 cases under the PDRA in which it demanded a cumulative total of BDT 1,400.58 (million) or \$18.09 million, but collected only approximately 0.5 percent of what it sought (BDT 7.1 million or \$.09 million). In only 3 cases was the full amount demanded paid and 74 percent of the cases (104 of the 140) were not heard. Based upon the information provided by the Law Department in the above tables, it appears that the PDRA (the General Certificate Court) has been ineffective in the role envisioned under the Ordinance, *i.e.*, the forum where the BSEC can recover fines and penalties.

The "good news" from the perspective of BSEC enforcement is that despite a large portion of the cases not being heard and a lack of financial recoveries by the BSEC, issuers filed reports with the BSEC in 89 percent (125 of the 140) of the cases filed. However, the chief conclusion to be drawn from the ineffectiveness of the General Certificate Court and the Ordinance's requirement that the BSEC sue under "as an arear of land revenues," is that the BSEC's repeated failure to collect the amounts

demanded in cases under the PDRA has eroded, and is continuing to erode, the credibility of its sanctions. To more effectively deter violations of the securities laws, the BSEC must have a credible means of collecting fines and sanctions.

Alternatives - The BSEC may wish to explore possible alternatives that may be available under Bangladesh law, including non-judicial dispute resolution, to create a more effective way to improve the credibility of its enforcement program. Among the possibilities that might be implemented through BSEC rules are requiring issuers and intermediaries (i.e., broker/dealers, merchant banks, asset management companies, credit rating agencies, etc.) and their officers and directors, as a condition of licensing and issuers and their officers and directors, as a condition for an application for listing:

- To agree to submit to and be bound by decisions of the SCMT regarding fines and penalties assessed by the BSEC including those relating to short-swing profits;
- To agree to submit to and be bound by decisions of an arbitrator³⁶ regarding fines and penalties assessed by the BSEC; and
- Assuming that many of the cases under the PDRA fail because of lack of service of summons or because of writs challenging jurisdiction of the General Certificate Court, to require consent to jurisdiction of the General Certificate Court as a condition of licensing and/or of an application for listing or continued listing of securities.

The BSEC may also wish to strengthen its enforcement program, as many other regulators (including the U.S. SEC) do, by considering whether failures to file, or late filing of required reports, may be an indication of possible financial mismanagement or worse. The BSEC may consider whether such failure to file or untimely filing should trigger an investigation, appointment of a special auditor or result in a suspension of trading in the issuer's securities until the required reports have been filed.

5.2 Strengthening Enforcement – Augmenting the Legal Staff

Under CMDP II we recommended increasing the number of lawyers engaged by the BSEC to strengthen its enforcement capacity. This would, in due course, enhance the capacity of the Enforcement Department to conduct investigations, collect and weigh evidence and of the Law Department to prosecute its cases. We also recommended that the BSEC receive training in investigative techniques and building and prosecuting legal cases. The lasting benefits of enforcement training would be enhanced to the extent that BSEC can add more attorneys to its staff.

A larger number of well qualified lawyers, trained in the use of investigation and enforcement techniques, would enable the BSEC to conduct more thorough

³⁶ We are exploring the alternative dispute resolution programs that have been found practical and accepted under Bangladesh law.

investigations and prepare stronger, more sustainable legal cases. Although in BSEC cases the defense has the burden of proof, the BSEC should prepare its cases in greater detail as if it has the burden of proof. As indicated in Section 2.2, above, the BSEC has determined to hire more lawyers (Initiative 19) in part for “conducting investigations and in enforcement.”(CMDMP, Section 2.2.3, p.7), With the support of qualified and experienced attorneys, the Enforcement and Law Departments would be better able to anticipate and withstand challenges from skillful defense attorneys and to improve the success rate in BSEC enforcement cases. The BSEC will need to refocus its recruitment activities to hire many more attorneys.

5.3 Operationalizing the Special Capital Market Tribunal

The BSEC CMDMP calls for establishment of a Special Capital Market Tribunal (SCMT).

“We recognize that one of the principal impediments to the effective enforcement of securities laws and regulations in Bangladesh is the court system itself. Cases may drag on for years and sometimes decades in the court system. There were reportedly a large number of securities cases pending in the court system as today, some of which stem from the stock market crash of 1996. Part of the problem is that ordinary court dockets are seriously overcrowded, resulting in cases not being heard for months or even years. A second part of the problem is that defendants can sabotage the enforcement process by filing endless appeals. Initiative 40 [36] will insure the establishment of a specialized Capital Market Tribunal (CMT) that is appropriately constituted to ensure that its jurisdiction, functioning, status, the selection and training of judges, and its appeal procedures would facilitate the timely and effective adjudication of securities cases and help to improve the effectiveness of the SEC’s enforcement process.”³⁷

Under CMDP II, we supported the BSEC initiative to establish a Special Capital Market Tribunal. This initiative was intended to ensure that the jurisdiction, functioning and status of the Special Tribunal, the selection and training of its judges, and its appeal procedures would facilitate the timely and effective adjudication of securities cases and help to improve the effectiveness of the BSEC’s enforcement process.

An amendment to the Securities Ordinance (Section 25B) established the Special Capital Market Tribunal (SCMT). The SCMT was established by Notification of the Government in January 2014, and a Sessions Judge, Hon. Humayun Kabir, was appointed to the SCMT. Following his appointment, Judge Kabir visited Mumbai, India, where he had exchanged views with the Chairman and Members of the Securities and

³⁷ CMDMP, Section 2.2.8, p.10

Exchange Board of India (SEBI); the Securities Exchange Appellate Tribunal as well as officials of the National Stock Exchange. As of March 2015, the SCMT awaited only completion of its Courtroom and Chambers to begin operations.

The SCMT is empowered to hear criminal law cases. Of the 47 BSEC cases pending at the end of BSEC fiscal year 2014, 32 (68 percent) were criminal cases of which 27 (84 percent) had been pending for more than 5 years. New Section 25B(3) of the Ordinance permits the Court of Sessions upon its own motion or application by the BSEC to transfer any case from its court to another Special Tribunal. This provision should enable the transfer of cases from the docket of the Court of Sessions to that of the SCMT.

Case Management Rules - One of the principal impediments to the expeditious disposal of criminal cases has been inordinate delaying tactics permitted under the Code of Criminal Procedure, 1898. Asked about the possibility of adopting special procedures to expedite the cases before the SCMT, Judge Kabir explained that upon the establishment and operation of the SCMT, rules of procedure could be suggested to the Ministry of Law which could draft such rules. If adopted and appropriately administered, effective case management rules would provide significant assistance in expediting the operations and effectiveness of the SCMT.

Another ADB project³⁸ has prepared a draft of "Case Management Rules for the Special Tribunal" which are designed to expedite the just disposal of criminal cases. These rules include provisions relating to active case management; case progression officers; case management powers; plea and case management hearings; and conduct of a trial: its preparation, readiness and management.

Active case management - Active case management includes early identification of real issues and the needs of witnesses and achieving certainty as to what must be done, by whom and when. This involves early setting of a timetable for the progress of the case and requires monitoring of the case's progress; compliance with directions and ensuring that evidence is presented in the shortest and clearest way. Participants must be encouraged to cooperate in the progression of the case; delay discouraged and as many aspects of a case as possible must be dealt with on the same occasion, avoiding unnecessary hearings. Courts should make use of technology to actively manage cases.

Case progression officers - The draft rules require the parties to actively assist the court in actively managing the case. They require each party to nominate a case progression officer responsible for progressing the case, and the court, where appropriate, to nominate a court officer to do the same. A Case Progression Officer monitors

³⁸ ADB TA-8228 BAN: Enhancing Efficiency of the Capital Market.

compliance with directions and keeps the court informed of events that may affect the case's progress. S/he must be able to be contacted promptly during ordinary business hours and act promptly and reasonably in response to case communications.

Case management powers - Ensuring that a case is actively managed lies in the court's power to give any direction or step unless it would be inconsistent with legislation or the Case Management Rules. Those steps or directions may include: giving directions on its own or a party's initiative (at a hearing, in public or private, or without a hearing); fix, postpone, bring forward, extend cancel or adjourn a hearing; shorten or extend a time limit fixed by a direction. It can require issues in the case be identified in writing, determined separately, and decide in what order they will be determined. It can specify the consequences of failing to comply with a direction (e.g., fix, postpone, bring forward, extend cancel or adjourn a hearing, make a cost order, or impose such other sanction as may be appropriate.) In some circumstances, it can refuse to allow a party to introduce evidence (it may be inadmissible) or the court may draw adverse inferences from the late introduction of an issue or of evidence. The court must be flexible. Case management rules also include permitting an application to vary a direction and agreement to vary a time limit fixed by a direction.

Plea and case management hearings³⁹- At every hearing, if a case cannot be concluded then and there, the court must give directions so that it can be concluded at the next hearing or as soon as possible thereafter. At every hearing, if the defendant is absent, the court must decide whether to proceed nonetheless; take the defendant's plea or find out whether the defendant is likely to plead guilty or not guilty; and set, follow or revise a timetable for the progression of the case (including a timetable for any hearing including the trial or appeal). Where a direction has not been complied with, find out why, identify who was responsible and take appropriate action. To prepare for trial, the court must take every reasonable step to encourage and facilitate the attendance of witnesses when needed and facilitate the participation of any person, including the defendant.

Conduct of a trial - To manage a trial the court, with the active assistance of the parties, must establish the disputed issues; consider setting a timetable that takes account of those issues and of any timetable proposed by a party, and may limit the duration of any stage of the hearing. It may require a party to identify which witnesses it wants to give evidence in person; the order in which that party wants those witnesses to give their evidence; whether that party requires an order compelling the attendance of a witness; what arrangements are desirable to facilitate the giving of evidence by a witness; what arrangements are desirable to facilitate the participation of any other

³⁹ Plea and case management hearings take place on a running basis to guide the case to a hearing. They can narrow the issues by producing a list of agreed facts; disposing of all but essential issues and enabling "skeleton" arguments on the law to be submitted in advance of the hearing to give the judge time to properly consider the issues raised.

person, including the defendant; what written evidence that party intends to introduce; what other material, if any, that person intends to make available to the court in the presentation of the case; and whether that party intends to raise any point of law that could affect the conduct of the trial or appeal.

Under the case management rules, the court may limit the examination, cross-examination or re-examination of a witness; and the duration of any stage of the hearing. In giving directions, it must ensure continuity in relation to the court and to the parties' representatives where that is appropriate and practicable.

Trial preparation - To prepare for a trial, the court must conduct a plea and case management hearing unless the circumstances make that unnecessary. The defendant must notify the court officer of the identity of the intended defense trial advocate as soon as practicable and in any event no later than the day of the plea and case management hearing (if there is one). The defendant must notify the court officer in writing of any change in the identity of the intended defense trial advocate as soon as practicable and in any event not more than 5 business days after that change.

Readiness for trial - Trial includes any hearing at which evidence will be introduced. Each party must comply with directions given by the court; take every reasonable step to make sure his witnesses will attend when they are needed; make appropriate arrangements to present any written or other material; and promptly inform the court and the other parties of anything that may affect the date or duration of the trial or appeal, or significantly affect the progress of the case in any other way. The court may require a party to give a certificate of readiness.

Trial management - To manage a trial the court must establish, with the active assistance of the parties, what are the disputed issues; consider setting a timetable that takes account of those issues and of any timetable proposed by a party. It may limit the duration of any stage of the hearing; require a party to identify which witnesses that party wants to give evidence in person; determine the order in which that party wants those witnesses to give their evidence; and whether that party requires an order compelling the attendance of a witness; what arrangements are desirable to facilitate the giving of evidence by a witness; what arrangements are desirable to facilitate the participation of any other person including the defendant; what written evidence that party intends to introduce; what other material, if any, that person intends to make available to the court in the presentation of the case; and whether that party intends to raise any point of law that could affect the conduct of the trial or appeal. It may limit the examination, cross-examination or re-examination of a witness; and the duration of any stage of the hearing.

Case management forms and records - The Case Management Rules state that case management forms should be used where available and where there is no particular form then no specific formality is required. The court must make available to the parties a record of directions given. Where a person is entitled or required to attend a hearing, the court officer must give as much notice as reasonably practicable.

The above description of the case management rules provide an excellent model which would help the SCMT fulfill one of its goals, a speedier docket. Because these rules represent best practices, the SCMT may wish to adopt them as prepared by the ADB Project TA-8228 BAN or to adopt workable case management rules patterned on them that capture their intent.

Recommendation 9: The BSEC may wish to consider the adoption and implementation of case management rules by the SCMT not later than one year after it is first convened and its operations commence (second tranche policy action). Such case management rules could either be those proposed by TA No 8228 BAN or workable case management rules patterned after them that capture their intent. At a minimum they should address: active case management; case progression officers; case management powers; plea and case management hearings; and conduct of a trial: its preparation, readiness and management.

5.4 Enhancing the Quality of Financial Reporting

In the CMDMP, BSEC clearly affirmed the need to address the quality of financial reporting. It stated:

"Two factors significantly impede the SEC's ability to sanction auditors who are not effectively monitoring issuers of securities. First, the SEC's efforts to discipline auditors pursuant to 12(b) (3) of the SEC 1987 Rules have been frustrated by the requirement to refer disciplinary actions against auditors to the Institute of Chartered Accountants of Bangladesh (ICAB). A Financial Reporting Act (FRA) has been under discussion for the better part of the last decade, and we recognize that its adoption is long overdue. Initiative 41 [37] is intended to address this matter. Second, the SEC does not have an Office of Chief Accountant; an office which can monitor the performance of accountants who practice before the SEC (i.e. who prepare and audit the financial statements of issuers of securities), and sanction them for poor performance. Initiative 46 is intended to address this matter."⁴⁰

⁴⁰ CMDMP, Section 2.2.8, p. 10

The quality of financial disclosure remains a major impediment to the development of Bangladesh's capital markets. At our June 25 Workshop, approximately 80% of the participants in one of the break-out sessions reported concerns with the quality of financial reporting. These concerns were reconfirmed in subsequent 1 on 1 discussions with stakeholders. The lack of quality of the financial information in Bangladesh's capital markets is a long standing fundamental flaw that contaminates the flow of information on which successful capital markets must be built. The lack of reliable financial information reverberates through the entire market and diminishes trust and confidence in it.

Responsibility for preparation and approval of financial reporting of public companies, and of licensed intermediaries, rests in the first instance, with issuers and intermediaries and their accountants who initially prepare their financial statements. A critical role is played by the auditors who certify financial statements for filing with the BSEC.⁴¹ The Institute of Chartered Accountants of Bangladesh (ICAB) is responsible for licensing, monitoring and disciplining accountants and auditors. It plays the key roles of assuring that its members are well-trained, maintaining the quality of accounting and auditing, and disciplining those members that fail to meet high standards of professionalism.

Under CMDP II, we proposed three approaches to improving the quality of public financial reporting to be pursued in parallel. These are:

- Supporting the proposal for enactment of a Financial Reporting Act (FRA) that would establish an independent oversight body, (a Financial Reporting Council, FRC), to oversee the profession, adopt, monitor and enforce accounting and auditing standards, and provide a procedure for review of disciplinary decisions;
- Supporting ICAB's efforts to reorganize and strengthen its operations; and
- Recommending the establishment of an Office of Chief Accountant at the BSEC and the appointment of its first Chief Accountant (CA) who would develop and adopt guidelines for accrediting/authorizing auditors to practice before the BSEC.

Actions, in varying degrees, have been taken in each area.

5.4.1 The Financial Reporting Act (FRA)

Initiative 37 of the BSEC CMDMP called for adoption of a Financial Reporting Act (FRA)⁴² The Draft Financial Reporting Act (DFRA) currently under consideration is intended to

⁴¹ As indicated in Section 2.5 of this report, Merchant Banker/ issue managers should also play a significant role in assuring the reliability of the information contained in IPOs.

⁴² CMDMP, Table 2, p.6

establish the Financial Reporting Council (FRC) to bring financial reporting of public interest entities (PIEs) under a well-regulated framework with the following objectives:

- Improving the quality of accounting and auditing services;
- Enhancing the credibility of auditing reports; and
- Improving the capacity of the accounting and auditing profession.

In so doing, the FRC will adopt standards of accounting and auditing, ensure accountants and auditors comply with these standards, and carry out other relevant functions.⁴³

Among other things, the FRC is authorized to:

- Adopt and enforce financial reporting and auditing standards commensurate with internationally accepted standards, “*given the socio-economic perspective of Bangladesh*”;
- Ensure compliance with standards adopted by the International Accounting Standards Board (IASB), the International Auditing and Assurance Standards Board (IAASB) or similar international organizations;⁴⁴
- Register auditors and establish and maintain a register of auditors;
- Monitor the auditing practice of auditors to maintain high standards of professional conduct;
- Monitor auditing practice activities of professional accountancy organizations, including reviews of regulatory arrangements, measures for developing the accountancy profession, and protecting the public interest as specified in their charters;
- Ensure effective compliance with the financial reporting and auditing standards it adopts, and with reporting requirements prescribed by any other (Bangladesh) act, through monitoring and enforcement;
- Conduct investigations and impose fines as prescribed by the FRA or the rules adopted under it.

⁴³ The FRC concept was originally introduced as part of a World Bank project in 2006, under which a Financial Reporting Act was proposed that would establish the FRC and provide for its powers and responsibilities (WB-FRA). An Ordinance (Financial Reporting Ordinance) was adopted in 2008 by the Interim Government of the time that kept many of the provisions of the WB-FRA intact. However, that Ordinance expired in 2009 following the election of a new government as it was never adopted by Parliament as a law.

⁴⁴ Adopting and enforcing auditing standards that take into account “*the socio-economic perspective of Bangladesh*,” appears inconsistent with ensuring compliance with the standards adopted by the IASB, and IAASB which do not take into account Bangladesh’s socio-economic perspective. The FRC may wish to address the possible inconsistency, as well as others pointed out below, after it has accumulated operating experience.

The FRC is organized in four divisions whose mutually supportive duties are set forth in Sections 23-26 of the DFRA. They are:

- The **Standard Setting Division** which frames and presents proposals for approval to the FRC relating to financial reporting, fixation of prices, actuarial standards, adoption, renewal, development and acceptance of auditing standards.
- The **Financial Reporting Monitoring Division** which monitors analyzes and identifies whether financial reporting and auditing standards, code of guidelines, adopted under the DFRA or any other acts, are being followed by public interest entities. If it determines that financial reporting and auditing standards codes or guidelines are not being observed by public interest entities or any other organization, it advises the Enforcement Division of its opinions and recommendations.
- The **Audit Practice Review Division** which monitors auditing practice activities of the professional accountancy organizations; reviews the auditing practice of any entity that helps registered auditors, audit firms or auditors; determines their compliance with auditing practice codes or auditing standards and reviews regulatory arrangements, i.e., whether the entity takes necessary initiatives for development of the accountancy profession by maintaining professional standards and whether it is protecting the public interest as specified in its charter.
- The **Enforcement Division** which receives opinions and recommendations of other divisions or matters relating to failures to comply with or violations of standards adopted under any other act referred to the FRC by other organizations, and after investigation, makes recommendations, as appropriate, for punitive measures as specified in the DFRA.

5.4.2 Responsibilities of the FRC

In practical terms, the DFRA would require every auditor and audit firm of a public interest entity (PIE) to be registered with the FRC to comply with the rules, guidelines, and standards adopted by the FRC, and to follow minimum conditions specified in auditing standards.

The FRC would be responsible for monitoring the audit practice of registered auditors and could investigate allegations of dishonest audits, negligence or professional misconduct; violations of the auditing practice code; material irregularities; or violation of any condition of the FRA, or "rules, statute, guidelines, standards or directives" under

it by a registered auditor. It could levy fines for violations which may be enforced under the Public Demand Recovery Act, 1913 (PDRA).⁴⁵

Through its Audit Practice Review Division, the FRC would be responsible for monitoring audit practice activities of professional accountancy organizations;⁴⁶ as well as, on a random basis, the audit practices of any entity that assists a registered auditor.

5.4.3 Council Members

The DFRA envisions an FRC under an 11 member Council of which the Chairman would be appointed by the government and the Executive Director would be appointed by the Chairman. The nine other members include representatives of five government agencies, of the Federation of Chambers of Commerce, ICAB and ICMAB as well as an accounting professor appointed by the GoB.

By contrast the WB-FRA contemplated a 12 member FRC which included two “Expert Members”, appointed from amongst persons with demonstrated expertise and practical knowledge of international financial reporting and international auditing standards. Under the DFRA, a Selection Committee (Auditor & Comptroller General, a nominee of the Public Service Commission and Secretary of the Finance Division) is responsible for recommending two persons each for the positions of Chairman and Executive Director.⁴⁷

5.4.4 Funding

The DFRA (Section 53) envisions a “Financial Reporting Council Fund” (Fund) supported by government grants, fees charges and administrative fines,⁴⁸ money for services of the FRC and money received from any other legal source. The financial resources of the Fund would be required to be deposited in a scheduled bank in the name of the FRC. Upon meeting its expenses, the FRC must deposit any surplus with the consolidated account of the GoB. The WB-FRA authorized a similar Fund that was controlled by the FRC. Any surplus in that Fund would have been retained by the FRC.

⁴⁵ As explained above in Section 5.2 in connection with enforcement activities of the BSEC, it has been largely unsuccessful in recovering fines under the PDRA.

⁴⁶ Article 2(19) defines only the Institute of Chartered Accountants of Bangladesh (ICAB) as a professional accountancy organization, omitting the Institute of Cost and Management Accountants of Bangladesh (ICMAB).

⁴⁷ The WB-FRA contemplated a Selection Committee to recruit the Executive Director of the FRC through an open and transparent process, including advertisements in international media, and from persons with international experience in accounting, auditing, law, economics and management, having practical executive experience, as may be determined by rules of the FRC.

⁴⁸ A possible internal inconsistency exists with respect to the depositing and control of administrative fines under DFRA Sections 53 and 49. Section 49, unlike Section 53, requires such fines to “be deposited with the Government’s Exchequer.” This possible inconsistency should be clarified in the course of the FRC’s operations.

5.4.5 Remuneration and Staffing

Under the WB-FRA, the status, pay and allowances of FRC Members was to be determined by rules to be prescribed by the FRC. DFRA Section 14 requires the government to determine the remuneration of the Chairman and Executive Directors by rules or general order of the government until the FRC's rules are framed.⁴⁹ It states:

“The Government shall determine by rules the remuneration, allowances, facilities and other conditions of the services of the Chairman and Executive Directors: Provided, the said conditions shall be made effective through a general order issued by the Government for this purpose until the rules are framed.”

Section 18 of the DFRA requires the FRC, *with prior government approval*, to appoint as many officers and employees as are deemed necessary to carry out its functions. It also specifies that “*Procedures of appointment of officers and employees of the Council and terms and conditions of their service shall be determined by rules.*” (It is unclear whether or not the rules to which the FRC's hiring and remuneration are subject include the Table of Organogram and Equipment - TO&E). We would expect that it would be difficult to hire experienced auditors and/or accountants in leadership positions under the government pay scale and would recommend that the Chairman and Executive Directors of the FRC be hired under contracts for their terms of office.⁵⁰

5.4.6 Prior Approval from Government

As indicated above, Chapter Four, Section 22 of the DFRA establishes four FRC Divisions to fulfill the objectives of the DFRA. Sections 23-26 define the duties of each Division. After setting forth specific duties, each of those sections contains a sub-section that requires that the FRC,

“**subject to prior approval from the Government**, determine the grounds and procedures for carrying out functions of the [...name...] Division by framing statutes through official gazette notification to fulfill the objectives of this Act.”⁵¹

With respect to the Standard Setting Division, this sub-section adds “*without affecting the totality of sub-clause 1*” (i.e., specific duties). The sections relating to the Financial Reporting Monitoring and the Audit Practice Review Divisions also contain a sub-section that appears to contradict the need for prior government approval. It states:

⁴⁹ In addition to the Executive Director of the Council, the DFRA envisions Executive Directors of Four Departments of the FRC.

⁵⁰ The BSEC has, by virtue of an exception that permits it to hire outside consultants under contract, been able to hire a Chief Accountant, but only for short 3 and 6 month periods.

⁵¹ DFRA, Sections 23(2), 24(2), 25(2) and 26(2).

"The [...name...] Division shall, subject to this Act and statutes to be framed under this Act, carry out [...name...] activities in accordance with procedures adopted by it."⁵²

The DFRA does not have a similar clause that would permit the Enforcement Division to carry out its activities in accordance with procedures adopted by it. These provisions raise the question of whether the requirement of prior government approval is procedural only or whether it permits the government to determine the operating procedures of each Division of the FRC.

5.4.7 Operationalizing the Financial Reporting Council

The FRC would need to take a number of organizational initiatives in its first year of operation to prepare it to fulfill its responsibilities. First and most basic are initiatives that would ensure that the FRC is solidly established, engages the best and most talented leadership and has well thought out, workable strategic and business plans.

The DFRA appears to require the appointment of six FRC executives: a Chairman; an Executive Director of the FRC;⁵³ and one Executive Director for each of the four FRC operating Divisions.

The DFRA requires the FRC Selection Committee to recommend both a Chairman and an Executive Director of the FRC, "two names of competent persons against each position." The Chairman, who is appointed for four years, must have 15 years of executive-level experience and a post-graduate degree in accounting, economics, law or financial management and cannot hold office beyond the age of 65. Candidates for Executive Directors of the Standard Setting, Financial Reporting Monitoring, and Audit Practice Review Divisions are required to have "a minimum of 10 years of practical experience in international financial reporting standards, international auditing standards, etc." Candidates for Executive Director of the Enforcement Division must have a Bachelor's (Honours) degree..." and "at least 10 years of working experience required for the said (division)."

Because the DFRA contemplates a narrower hiring search and less stringent standards than the WB-FR,⁵⁴ which was international in scope, the responsibilities of the Selection Committee will be focused on Bangladeshi candidates. The narrower hiring search

⁵² DFRA, Sections 24(5) and 25(5).

⁵³ Unlike with respect to the Chairman and Executive Directors of the FRC's Technical Divisions, the DFRA omits any description of the standards for hiring and term of the Executive Director of the FRC. This may be intentional or a drafting or translation error. It would seem more practical, and considering the scarcity of resources, that the Chairman would serve as the Executive Director of the FRC. Determining the role and standards for hiring the Executive Director of the FRC should be one of the first questions to be resolved by the FRC.

⁵⁴ The WB-FRA required the executive members to be recruited through an open and transparent process, including advertisements in international media, and to be appointed from amongst persons with demonstrated expertise and practical knowledge of international financial reporting standards, international auditing standards and lawyers experienced in business litigation.

may also require greater focus on training the successful candidates to meet their responsibilities.

The FRC must adopt a budget, a strategic plan and a business plan to guide it in achieving its objectives, exercising its powers and discharging its responsibilities (established in DFRA Sections 7 and 8). DFRA Section 55 requires that the FRC budget set forth the financial resources it will need for its subsequent financial year. For its first year, without operating experience on which to base its projections, this could be a difficult exercise. DFRA Section 55 requires the FRC to prepare and submit to the government a work plan (Business Plan) and work strategies (Strategic Plan) annually. These plans are critically important for setting practical long term goals, planning the step by step development of the FRC and the estimating and achieving the income stream required for effective operations.

To ensure the smooth functioning of each division and thus the efficient functioning of the FRC, each Executive Director and the employees of each division must understand the mission of the division; how it is to be accomplished; their role (job description) and how the division interacts with other divisions and the FRC. The FRC and the divisions should also clarify the extent to which they or the government determine their activities and procedures.⁵⁵

5.4.7.1 Developing and Adopting Rules, Standards and Guidelines

In addition to the organizational activities described above, the FRC will need to formulate and put in place a number of specific rules, guidelines, standards and/or codes as required by the DFRA; establish procedures for discovery, review and sanctions for material irregularities by auditors of PIEs; establish procedures for review and evaluation of the practices of professional accountancy organizations; and resolve issues that may arise in applying the definition of PIE. Specifically, the FRC will need to:

- Develop and adopt rules setting forth the conditions and procedures for the registration of auditors (DFRA Section 32), a fundamental procedure which is the starting point for regulation of the auditing profession.
- Adopt financial reporting standards;
- Adopt auditing standards;
- Develop and adopt an “auditing practice code, guidelines or statute to regulate financial reporting activities by enlisted auditors and public interest entities” (Section 27).

⁵⁵ As indicated above, the FRC determines the grounds and procedures for carrying out each division’s functions, *subject to prior approval of the government*, by framing statutes through the official gazette notification. However, the Financial Reporting Monitoring and Audit Practice Review Divisions carry out their activities in accordance with procedures adopted by the division. It must be determined to what extent the government must approve the functions and activities of each division.

- Develop and adopt a “code of professional and moral conduct to establish standards of professional conduct while performing respective duties and responsibilities by the members and officials and employees” (Section 28);
- Establish procedures for review and evaluation of the practices of professional accountancy organizations;
- Formulate and adopt memoranda of understanding or other legal documents for the exchange of information with Bangladesh Bank, Bangladesh Securities and Exchange Commission, Insurance Development and Regulatory Authority, and any other statutory organization or entity concerned (Section 29).

5.4.7.2 Clarifying Questions and Resolving Inconsistencies

In reviewing the DFRA, as it affects the operation of the FRC, we have pointed out questions relating to the need for government approval that should be addressed and possible inconsistencies that should be reconciled and resolved over the course of time as the FRC gains experience.

The extent to which the government can determine operating procedures of the technical divisions, may affect the flexibility and effectiveness of the FRC. As stated in the preamble to the DFRA, it is “Proposed to make provisions for establishing an independent Financial Reporting Council...” In our view, the preamble should guide interpretation of the DFRA and where questions arise they should be resolved in favor of independence.

Whether the standards to be adopted and enforced by the FRC should be the unadulterated standards of the International standard setting bodies or should be ones that are somehow modified to reflect Bangladesh's “socio-economic perspective”, can strongly influence investment decisions of international investors, as this affects the direct comparability of potential investments. If they are confident that the accounting and auditing standards adopted and enforced in Bangladesh are exactly those of the international standard-setting bodies that are recognized around the world, international investors may be more likely to invest than if they have to evaluate the differences arising from modifications. Therefore we would suggest that adoption of international standards without modification (for PIEs) would support and encourage greater participation by international investors in Bangladesh's capital markets.

Whether the administrative fines collected by the FRC are deposited in the government's Exchequer or held in a scheduled bank in the name of the FRC can affect the FRC's financial resources, as well as the size of the grants it receives from the government. Allowing the FRC to hold the administrative fines it collects in a bank would provide the FRC with some measure of flexibility and slightly more control over its finances.

Defining the role of the Executive Director of the FRC and establishing a set of minimum qualifications for the successful applicant will be one of the first areas needing to be addressed by the FRC and its Selection Committee. Because of the considerable responsibilities of the Chairman, the role of the Executive Director may not need to be very broad and may be limited to an operational one.

Recommendation 10: As a *First Tranche Policy Action*, ADB may wish to consider requiring the appointment of the FRC's Executive Team (i.e. Chairman and all five Executive Directors) as per the requirements of the DFRA.

Recommendation 11: As a *Second Tranche Policy Action*, ADB may wish to require that the FRC complete the following:

- Develop and adopt a budget, strategic plan and business plan;
- Develop and adopt rules setting forth the conditions and procedures for the registration of auditors;⁵⁶
- Adopt accounting standards;
- Adopt auditing standards;
- Develop and adopt an Audit Practice Code;
- Develop and adopt standards of professional and moral conduct;
- Enter into memoranda of understanding (MOUs) with Bangladesh Bank, BSEC and IDRA; and
- Develop and adopt procedures for discovery, review and sanctions for material irregularities by auditors of public interest entities.

5.4.8 ICAB Efforts at Reform

ICAB has taken significant steps and devoted considerable energy and resources to improving its Quality Assurance Program, making its Disciplinary Program more effective and upgrading its Continuing Education Program.

Quality Assurance - ICAB's Quality Assurance (QA) program draws heavily on that of the Institute of Chartered Accountants of England and Wales (ICAEW). It has adapted inspection procedures from the ICAEW; and uses its seven point checklist in its QA program which has reached a three year cycle for all members. A central issue is how ICAB's QA Program for accountants in public practice (i.e., auditors whose clients are listed companies or BSEC licensees) differs from its QA program for other members and how this program can be strengthened.

⁵⁶ DFRA Section 32

Discipline - One of the principal shortcomings of ICAB, according to the BSEC, has been its lack of dedication to disciplining its members for violations of accounting and auditing standards. During our Inception Mission, ICAB indicated it was taking a more strict and rigorous approach to enforcing its standards. It called our attention to its recent disciplining of 20 members.

While these programs have improved ICAB, ICAB cannot be completely effective. As indicated in the World Bank's Report on the Accounting and Auditing Observance of Standards and Codes, 2003 (AA ROSC Report) fundamental weakness in Bangladesh's accounting and auditing can be traced to the lack of authorization of ICAB to establish/adopt accounting and auditing standards in its founding legislation (Bangladesh Chartered Accountants Order 1973, Presidential Order No. 2 of 1973). The absence of such authority means there is no legal basis for ICAB to establish/adopt standards or to enforce these standards. Until ICAB adopted an Audit Practice Manual in April 2009, there was a lack of guidance for ICAB member auditing firms, other than for internationally affiliated firms that receive guidance through their international

5.4.9 Office of Chief Accountant of the BSEC

Initiative 41 of the CMDMP was to "Establish the Office of Chief Accountant and recruit & train accountants"⁵⁷. The BSEC has established an Office of Chief Accountant (OCA) and engaged a Chief Accountant (CA) who began work on September 1, 2014.⁵⁸ Among the responsibilities of the CA will be to:

- Upgrade the quality of financial information in the capital markets;
- Enhance the accounting/auditing review capacity of the BSEC –his office should be a resource for all of the BSEC's Departments; and
- Serve as the BSEC's liaison to ICAB, the BB, IDRA and other groups concerned with the quality of accounting and auditing.

The overriding objective of the OCA should be to improve the quality of financial reporting of issuers of securities and licensees subject to BSEC regulation (regulated entities). The CA will need to make decisions on the best and most effective ways to accomplish this objective with the tools he has at his disposal. One of the tools at the disposal of the CA is the authority conferred on the BSEC by Section 2CC of the Securities and Exchange Ordinance (Ordinance) to impose conditions on the issue of capital, prospectuses and other documents and the purchase of securities. Another tool is found in Section 8 (b) of the SEC Act, that empowers the BSEC to regulate the functions of stock brokers and other intermediaries.

⁵⁷ Table 2, p.6

⁵⁸ The contract of the CA was authorized under Section 9A of the SEC Act which requires prior approval of the government. It was for a period of only three months and was subsequently renewed. A much longer, more sustained relationship will be necessary and the BSEC and the CA envision a longer term relationship.

Our reading is that these provisions authorize the BSEC to accredit/authorize auditors of issuers and regulated entities to practice before the BSEC. Indeed, provisions of the Securities and Exchange Rules, 1987, have already established a precedent in this respect. Section 12 (3) of those rules requires the financial statements of an issuer of a listed security to be audited by a partnership firm of chartered accountants of not less than two partners in practice for a minimum of seven years none of whom were associated in any way with the issuer during the auditing period. These rules will need to be closely examined to determine the changes that may need to be made to them to better control the quality of financial information emanating from the entities (public companies and licensed intermediaries) within BSEC's regulatory perimeters.⁵⁹

5.4.10 Establishing an Auditor Authorization/Accreditation Program

Establishing an auditor authorization/accreditation program will require an analysis of a number of issues relating to auditors. Among them are the appropriate standards to be applied and the quality of guidance provided and ICAB's certification processes. Under CMDP II, we proposed that the BSEC, through a process of "authorization" or "accreditation," control the quality of auditors that are authorized to audit the financial statements of regulated entities.⁶⁰ Some of the issues that the CA will need to considered are:

- Which standards should be applicable? International Standards of Auditing (ISA) or Bangladesh Standards of Auditing (BSA)? The existing requirement in Section 12 of the SEC 1987 Rule are confusing because they refer to International Accounting Standards "as adopted by the ICAB" which leaves the reader to guess whether the standards refer to IAS/IFRS or those that have been adopted by ICAB. A "clarification" serves to further confuse the issue. It refers to the standards issued by the International Accounting Standards Committee which no longer is the appropriate issuing authority.
- Should firms, individuals or both be accredited?
- Should auditors receive guidance consistent with international standards? Is the guidance provided by ICAB's Audit Practice Manual sufficient to eliminate confusion and maintain high standards? If ICAB guidance does not meet international best practice standards, how and why does it depart and whether or not it plans to bring its guidance into compliance with international best practice? Is additional guidance - such as that received by internationally

⁵⁹ Adoption of the FRA and the establishment of an effective Financial Reporting Council (FRC) under it would provide additional oversight of those auditors engaged in a public practice [i.e., serving Public Interest Entities (PIEs)]. If an FRA is enacted, as described in Section 5.3,1 above,, it would provide the FRC authority to establish, monitor and enforce accounting and auditing standards.

⁶⁰ Among the many responsibilities we envision for the CA would be to establish the Office of CA to service the other offices of the BSEC. This would include assisting in the drafting of Guidance for the preparation of IPOs and due diligence as discussed in Section 2.5 of this report.

affiliated firms - required? After an audit firm has been authorized/accredited by the BSEC, how can the BSEC ensure that it has maintained its qualifications and continuing eligibility to audit reports filed with the BSEC? Should there be a process for rechecking after a certain period? Should the accountants who prepare the financial statements of listed companies and licensees be required to be Chartered Accountants?

Among the “models” available for the CA to draw upon in determining the authorization/accreditation standards to apply are:

- Those established by the BB and adhered to by entities regulated by it;
- Those established by the BSEC for auditing the financial statements of companies making an initial public offering of equity shares (IPO) and using the “book building” (i.e., internationally affiliated firms);
- Criteria established by foreign securities market regulators for qualifying auditors whose practices include public companies;⁶¹ and
- Criteria established by Independent Auditor Regulatory Authorities around the globe.

In view of the fact that adoption of “guidelines for the accountants and to practice before the SEC” is a Policy Action under the Second Tranche of CMDP III, and that the BSEC will likely want to satisfy this conditionality quickly, a two-step approach to this matter might be appropriate. The first step might be to adopt an already-existing standard (i.e. either that of the BB or BSEC’s own standard established for the “book-building”). There are two reasons that weigh heavily in favor of applying the second option – i.e. accrediting auditors affiliated with international firms.

The first is that precedence has been established for this approach. This criterion has already been established and accepted by the BSEC and the market has been exposed to it.⁶² The second is that in such situations it is always better to start with higher (more restrictive) standards that can be relaxed in due course as experience dictates. Starting with more restrictive standards and relaxing, is a situation that would be far easier to control. The relaxation of criteria and the admission of new segments of the accounting/auditing profession could be predicated on achieving certain quality

⁶¹ The U.S. Public Companies Accounting Oversight Board applies standards for Members of its SEC Practice Section. SEC Practice Section (SECPS) - Requirements of Membership that include: Continuing Professional Education of Audit Firm Personnel; Communication by Written Statement to all Professional Personnel of Firm Policies and Procedures on the Recommendation and Approval of Accounting Principles, Present and Potential Client Relationships, and the Types of Services Provided; Notification of the Commission of Resignations and Dismissals from Audit Engagements for Commission Registrants; Audit Firm Obligations with Respect to the Policies and Procedures of Correspondent Firms and of Other Members of International Firms or International Associations of Firms; and Policies and Procedures to Comply with Independence Requirements.

⁶² The BMBA has also recommended that only auditors affiliated with international firms be permitted to audit companies making an IPO.

milestones. Taking this “carrot and stick” approach could, in itself, catalyze improved performance among auditors on a voluntary basis.

Finally, this approach is supported by research finding “foreign affiliation” to be one of the key determinants of financial statement quality.⁶³

If and when BSEC becomes convinced that there are good and sufficient reasons to broaden this initial criterion, it may do so. In the first instance, however, this criterion appears most acceptable.

Recommendation 12: The BSEC, with the analytical assistance of the CA, may wish to assess the adequacy of the SEC Rule, 1987, for accrediting/authorizing auditors of public companies and regulated entities in order to improve the quality of financial reporting in the market, and amend the rule accordingly to achieve that goal.

5.5 Reporting and Recovery of Short Swing Profits

The concept of recapturing the “short swing” trading profits of corporate insiders originated in the U.S. Studies found that insiders were managing companies for their own short term benefit. The U.S. Securities Exchange Act of 1934 (Exchange Act) includes a “short swing profit” provision intended to discourage the management of a company for the personal gain of its management and to help ensure that the focus of management is on long term benefits for all of the company’s shareholders.⁶⁴

5.5.1 Bangladesh’s Short Swing Profit Provision

Such a provision is also part of the legal framework in Bangladesh. Section 12 of the (Ordinance) requires officers, directors and 10% owners of listed companies (“statutory insiders”) to submit reports to the BSEC of their beneficial ownership of the securities of any company in which they are a statutory insider. Section 14 sets forth the requirements for capturing the “short swing profits” of such statutory insiders. In short, it requires that each such insider report any gain from the purchase and sale, or the sale

⁶³ “Determination of IAS Disclosure Compliance in Emerging Economies: Evidence from Exchange listed Companies in Bangladesh,” Working Paper No. 21, 2005, Center for Accounting Governance and Taxation Research, AKM Waresul and Jamal Uddin Ahmed, School of Accounting and Commercial Law., Victoria University of Wellington, New Zealand

⁶⁴ Such provisions have been adopted by many market regulators. An OECD Study, MISUSE OF PRIVILEGED INFORMATION: COSRA/IARC/Latin American Roundtable, SURVEY, September 15, 2011, stated:

“Trading by company insiders should be as transparent as possible. Investor confidence increases as the public capital market has greater access to timely information about trading by corporate insiders. As a consequence, a number of jurisdictions surveyed require reporting of trades in company shares by managers, directors and controlling shareholders. A few markets... include in their legal frameworks a “short-swing” profit rule requiring insiders to return to the company any profits earned through the purchase and sale of shares within suspiciously short periods.” p.35

The Vietnamese Securities Law adopted by the Government, effective from January 2007, “contains a short swing profit prohibition against insiders (members of management, general director, deputy general director, financial manager, accountant, and other management officers) who are prohibited from buying and selling shares of that public company within a 6-month period. Under Section 31, shareholders can recover profits gained from these transactions, which are deemed illegal.”Asian Development Bank, Proposed Program Cluster and Loan Socialist Republic of Viet Nam: Third Financial Sector Program Loan (Subprogram 1), Project Number: 37577, November 2007, p. 21.

and purchase, of any such security within a six month time frame, and tender the amount of such gain to the issuer.^{65 66}

Profit calculation – “Short swing profits” for the purposes of Section 14 are calculated (as they are under the Exchange Act) differently and more inclusively than they may be for tax or other accounting purposes in order to achieve the provisions’ purposes. “Short swing profits” are calculated taking the highest sales prices received by an insider over a six month period on sales of his company’s equity securities and netting those prices against the lowest purchase prices paid by the insider for his company’s equity securities during that same period. For purposes of Section 14, it is irrelevant whether the purchase precedes the sale or the sale precedes the purchase.⁶⁷ This provision is designed to discourage insiders from making short term transactions in their company’s securities, even unprofitable ones,⁶⁸ and to encourage them to run their companies for the longer term. Therefore, profits under the provision are calculated irrespective of what certificates for the securities are delivered or designated by the insider during the period or of any other accounting treatment (e.g., LIFO, FIFO or average cost).

Recovery of profits - If the statutory insider fails to tender any such gain to the issuer, the issuer must demand relinquishment of such gain to it. If the insider fails or neglects to tender, or the issuer fails to recover any such gain within six months after its accrual, or within sixty days of a demand for it, whichever is later, the amount of the gain vests in the BSEC which may bring suit to recover it “as an arrear of land revenue,” i.e. in the Certification Court under the PDRA.

5.5.2 Implementing the Short Swing Profit Provision

To date, the BSEC has not implemented the “short swing profit provisions”.⁶⁹ To make this provision effective would require the adoption by the BSEC of a:

- **Rule** that requires regular timely reporting by *all* insiders of transactions in their company’s stock (not just those trades deemed by the insider to be within six months);

⁶⁵ Section 14 provides an exception for “a security acquired in good faith in satisfaction of a debt previously contracted.”

⁶⁶ In this section, we refer to Sections 12 and 14 of the Ordinance as the “short swing profit provisions”.

⁶⁷ Section 14 requires an insider who “makes any gain by the purchase and sale, or the sale and purchase, of any such (equity) security within a period of less than six months to make a report and tender the amount of such gain to the issuer.”

⁶⁸ If an insider who bought 1000 shares of his company’s securities in 2012 at BDT 100, sold 200 of those shares in September 2014 at BDT 80 and bought 200 more shares in October 2014 at BDT 75, he would have a “short swing” profit BDT 1000 (5 x 200) despite having lost BDT 4000 (20 x 200) on the September sale and being out of pocket after the transactions have been completed.

⁶⁹ In 2012, BSEC representatives reported that, because of lack of staff it had delegated the monitoring of such reports to the DSE. Corporations lack incentives and appropriate procedures for recovering such gains. The BSEC has not actively pursued violators of this provision. Representatives of the BSEC, when asked recently, were not aware whether forms for reporting insider transactions by insiders existed or which department was responsible for ensuring they were filed or for reviewing them.

- **Procedures** to monitor and enforce reporting of transactions by statutory insiders and failures by them to notify and tender short swing profits, and to assure collection of short swing profits from such insiders.

The obligation to file timely reports of all changes in ownership and the BSEC's program - including reports of insider transactions, enforcement of the filing requirements and gains recaptured - should be well publicized. The benefits of the rule and procedures should be explained to those directly affected by it (issuers, insiders, exchanges) and to the press and the effectiveness of the program should be closely tracked in the BSEC's quarterly and annual reports.

Effect on insider trading - Implementing the short swing profit provisions would not, by itself, prevent trading on inside information (i.e., trading on non-public price sensitive information) by insiders or others ("insider trading"). It would, however, if adequately publicized, be an ideal way to sensitize the market to what insiders are doing with their shares. Insiders' trades may reflect their evaluations of their company's operations and prospects.⁷⁰ Reporting of transactions and enforcement of the short swing profit provisions, combined with public availability of transaction information in trading reports makes available important information that could add significantly to the transparency of the market. Getting insiders into the habit of reporting their transactions - i.e. providing regular timely information about their purchases and sales - can be a first step in the effort to reduce and control "insider trading".

5.5.3 Adopting a Short Swing Profit Rule

Initiative 30 of the CMDMP calls for "strict enforcement of laws against insider "short swing" profits". (CMDMP, Table 2, p.6) To make the short swing profit provisions effective the BSEC would need to adopt a rule pursuant to Sections 12 and 14 of the Ordinance that prescribes the form and intervals for statutory insiders (officers, directors and direct and indirect beneficial owners of not less than 10% of an issuer's equity securities) to report their holdings, transactions and any short swing profits from those transactions and to pay such profits to the issuer. The rule should:

- Define critical terms, including "beneficial owner," "equity security;"⁷¹ "insider" and "short swing profit";
- Require statutory insiders (i.e. officers, directors and 10% beneficial owners, directly or indirectly, of any equity security of a listed company) to report to BSEC the prices and dates and amounts of any transactions in equity securities of any company in which they are a statutory insider within a fixed time frame (e.g. 10

⁷⁰ Or they may merely be based on personal needs - i.e., availability (or lack) of capital for other purposes (e.g. for buying a car, a house, paying college tuition, etc.).

⁷¹ The term "equity security" should be defined and clearly understood to include any security convertible into an equity security including convertible securities and derivatives (options and futures).

days) from the end of any month in which such transactions are effected (insider holdings and transactions reports);

- Require that any short swing profits (i.e., gains from purchases and sales and/or sales and purchase calculated as required under the rule)⁷² be reported by the insider to the issuer and to BSEC, and be relinquished to the issuer;
- Require that issuers/companies vigorously pursue (including through legal proceedings) their duty to recover any/all un-relinquished short swing profits for the benefit of all shareholders;
- Require that issuers/companies report any short swing profits relinquished to them by company insiders, and any actions taken by them to recover any un-relinquished short swing profits, and the results of such actions;
- Provide standardized forms for reporting all of the above;
- Require that all such reports be filed with the BSEC and copies be filed with the issuer and each exchange on which the issuer's equity securities are listed;
- Establish fines for failure of statutory insiders and issuers to file required reports; failure of statutory insiders to relinquish, and failure of issuers to recover short swing profits (e.g. increasing with the length and frequency of delinquencies, and in proportion to the magnitude of such short swing profits); and
- As a cross-check on whether or not all insider trading reports have been filed, require that issuers, in a specified section in their annual and quarterly reports, state the name of each insider who transacted in its securities during the time period addressed by that report and the details of such transactions, including whether or not these transactions resulted in any short swing profits, the amounts of such gains, whether or not these were voluntarily relinquished to the company, and the actions undertaken by the company to recover any unrecovered gains.

5.5.4 Adopting Monitoring & Enforcement Procedures

For the rule to be effective, the BSEC should adopt comprehensive procedures to monitor and enforce compliance with Sections 12 and 14 of the Ordinance and the rules under them. Such procedures should include:

- Regular review by the BSEC of insider holdings and transactions reports and of company quarterly and annual reports⁷³ to:
 - Determine whether or not all such reports have been filed in a timely manner;

⁷² Please refer to the paragraph above on "Profit - calculation" in drafting the required rule.

⁷³To supplement BSEC review procedures, issuers should be required to identify in their Annual Reports those of their insiders, if any, who failed to file or filed late reports of their trades in their company's stock as well as those that had short swing profits

- Analyze the reports to determine whether the insider realized any short swing profits, and, if so, verify the amount of such gains; and
- Assess and collect fines for late or incomplete reports or failures to file such reports;⁷⁴
- Regular monitoring of the trading activity of statutory insiders by the stock exchanges and BSEC to further identify failures to report transactions and/or late or incomplete filing of such reports;
- Notifying violators and issuers of violations and requiring that specific violators report and tender short swing profits to allow issuers to demand and take action to recover such profits;
- Public disclosure of information about the transactions of “statutory insiders”, which would include timely publication of dates and amounts of transactions by statutory insiders and of the amounts of any short swing profits realized by them;; and
- A vigorous enforcement program to recover short swing profits that companies have failed to recover.

5.5.5 Publicizing the Short Swing Profit Reporting and Recovery Program

To be effective, BSEC should publicize its “short swing profit reporting and recovery program” (SSPRRP). At the inception of the program, BSEC should make a concerted effort to explain its benefits (i.e. greater transparency of insiders’ transactions leading to better-informed investment decisions, reduced incentives for insiders to manage companies for their own benefit, leading to better managed companies) to those directly affected (issuers, insiders and the exchanges) and to the media.

To maintain accountability of this program, the BSEC should regularly report (in its quarterly and annual reports) of the number of insider holdings and transaction reports filed late in each period; the fines assessed and amounts collected for such late reports; the numbers of insiders who realized short swing profits; the total amounts of such short swing profits realized by each of them; the amount collected by their issuers; the amount collected by the BSEC; and the amount uncollected during each such period.

Recommendation 13: As a First Tranche Policy Action, ADB may wish to consider requiring the BSEC to develop and adopt a Short Swing Profit Reporting and Recovery (SSPRR) rule to give effect to the “short swing profit” provision that addresses the elements discussed in Section 5.4.3, above.

⁷⁴ As indicated at footnote 48, above, Section 22(1) of the Ordinance authorizes the BSEC to collect penalties for violations of the Ordinance. Section 22(2) requires that such penalties “be recoverable as an arrear of land revenues” i.e., under the PDRA, through a proceeding in the Certification Court in which, as indicated above, the BSEC’s ability to collect fines assessed has been largely ineffective. Section 14 also requires the same procedure under the PDRA for the BSEC to collect short swing profits.

Recommendation 14: As a Second Tranche Policy Action, ADB may wish to consider requiring the BSEC to develop and adopt procedures to implement the SSPRR rule, to include:

- Comprehensive and transparent monitoring and enforcement procedures to compel the timely filing of insider trading reports;
- Procedures to ensure the public disclosure of the information contained in insider holdings and transactions reports;
- Measures to effectively recapture un-relinquished short swing profits realized by company insiders.

5.6 Take-over Rule

While we have not had an opportunity to review and assess the Takeover Rule, (Acquisition of Substantial Share, Takeover and Control Rules, 2002) as this is only available in Bangla, we have been advised by BSEC officials that it is not currently being enforced due to its manifold deficiencies. Among the principal deficiencies described were that there is no explicit provision requiring "fair and equal" treatment of minority shareholders.

As written, it may be possible for directors of either the acquiring or target company, through their treatment and conduct of shareholders or by failure to act in good faith, to unfairly disadvantage shareholders, especially of the target company. A BSEC representative explained that the SEC does not enforce its Takeover Rule because it views it as impractical and burdensome. Separately, it was brought to our attention that because of delays in the court system, takeovers are too risky and impractical for potential bidders who are reluctant to tie up cash or go to considerable effort because a determined shareholder can singlehandedly defeat a takeover by bringing a lawsuit and endlessly appealing.

The present status of the Takeover Rule is inadequate. It should be completely rewritten incorporating the following principles:

- Information about the acquirer's background and intentions with respect to investment vs. control and eventual acquisition should be required, regardless of where else such information or parts of it may be required to be disclosed;
- Groups acting in concert, formed for the purpose of holding securities pursuant to a plan for holding or acquiring a defined amount of securities in a particular company should be required to report their positions and changes in their positions just as other individuals or entities; and
- A fair and effective takeover rule should:

- Provide all shareholders reasonable and equal opportunities to participate in any benefits accruing to shareholders under any proposal under which a person would acquire a substantial interest in their company;
- Hold management accountable for its actions;
- Ensure that minority shareholders receive fair and equal treatment in a takeover proposal; and
- Ensure that all shareholders receive disclosure of changes in controlling interests, and all information necessary for informed decision-making regarding tender offers, takeover bids and other transactions relating to effectuating a change in control, or that potentially may result in a change of control or a consolidation of control of shareholdings of senior management and of those persons who hold a substantial beneficial interest in the company.

In addition to full, timely and accurate disclosure, any redraft of the Takeover Rule should take into account fairness to all shareholders and the need for proportional distribution of benefits to all shareholders; and should consider the impact of the Companies Act requirements for empowering individual shareholders at a General or Special Meeting; and the rights of less than 10 percent minority shareholders.

Recommendation 15: The BSEC may wish to consider whether the Takeover Rule should be completely rewritten. It may be appropriate for the ADB to consider this as a candidate for “piggy back” assistance between First and Second Tranche disbursements of the CMDP III Policy Loan. The new rule would best be drafted through a tripartite working group that involves the BSEC and stakeholder representatives working with an international expert.

6 Market Development & Promoting Education & Understanding

Development of the market implies improving and expanding the market both quantitatively and qualitatively to promote more efficient allocation of capital. To do that a market development program needs to adopt programs that expand the knowledge and understanding of its investment base including both its domestic retail and institutional bases and its international base. Doing so provides a double benefit: it adds additional capital and wealth, and also provides more discerning and well-informed investors who through greater selectivity can demand higher standards and greater efficiencies that continually feed the market's development.

6.1 BSEC's Investor Education Program

The BSEC has acknowledged the importance of developing a vibrant and robust investor education program that is directed at market participants and potential investors.⁷⁵ BSEC's CMDMP states:

"The SEC is mandated by law and by its own policy to actively promote the development of Bangladesh's capital markets and to contribute to the education and understanding of capital markets with respect to the community it regulates as well as the broader general public. It presently does this through four principal means – through publishing an Annual Report; through its website; through its investor education programs; and through public statements such as press releases, speeches at industry events, etc. The SEC's Annual Report is informative and useful albeit lagging real-time events considerably; its website is considerably inferior to those of other regional financial regulators with respect to organization, content, ease of use, etc.; its investor education program is not well-targeted or actively promoted; and the effectiveness of its public statements in promoting understanding and education is limited.

An Initiative is planned to develop a comprehensive, well-designed, well-coordinated and well-executed public information and education program which incorporates at least two key elements: A completely revamped website with the objective of making it one of the primary vehicles for executing the SEC's mandate concerning promoting understanding and education of the securities markets; and a completely revamped investor education program, potentially with significant involvement of the Bangladesh Institute for Capital Markets (BICM)."⁷⁶

Until 3 or 4 years ago, subject to availability of registrants, the BSEC had conducted three Investor Education Programs per month including one only for women. Each was a two day program that included 11 topics. Those programs were discontinued because of lack of space in which to deliver them. The BSEC continues to offer training material on-line for each of the 11 topics. However, when we checked the materials were available on only two of the 11 topics (the Primary Market and Securities Analysis and Portfolio Management). To carry out its former program, the BSEC ideally would need, in addition to a classroom venue capable of holding 40 to 50 participants, at least 1 person to organize and coordinate the administrative aspects of the program; a knowledgeable coordinator who could train trainers, and quality staff to conduct programs.

⁷⁵ Banks have introduced similar programs for customers thinking of investing.

⁷⁶ CMDMP, Section 2.2.9, p.11

6.1.1 Benefits of an Expanded Program

The BSEC's Investor Education Program should be resumed in an expanded and strengthened form to carry out the BSEC's mandate under the SEC Act.⁷⁷ It is axiomatic that better informed/educated investors make markets more rational and efficient. More discerning investors would strengthen capital markets because they would:

- Demand better investment products and services leading to more competition among capital market intermediaries and issuers to develop new and innovative products and services.
- Understand the importance of saving and be inclined to save more. These increased savings would generate higher levels of investment and economic growth.
- In emerging economies, the preponderance of evidence shows that better information for investors and investing in their education results in better operation of the financial markets. Better educated investors are better able to protect themselves and to report possible misconduct by financial intermediaries. This results in better supervision of intermediaries and assistance to supervisory officials.

6.1.2 Content

To promote confidence in the markets and maximize the benefits that investors can obtain from the disclosure of information, it is important that they are aware of the role and limits of regulation and the need to understand and analyze the information provided. The BSEC is ideally positioned to educate potential investors on the nature of securities regulation. A refinement in the program would be to design separate tracks for more sophisticated institutional investors and for retail investors. The program would be more easily understood by professional market participants and professional investors than retail investors who need training in understanding risk.

The program should build an understanding of the capital market; the need for financial planning; the benefits of a long term perspective; and ultimately establish trust and confidence in the fairness of the market. As financial markets have become increasingly more sophisticated, investors have been able to trade on a variety of electronic devices and are able to choose among new and increasingly complex financial products. In Bangladesh, moreover, the culture of "guaranteed returns" and

⁷⁷ The SEC Act places the BSEC under a broad mandate to develop the capital markets: Sections 8 (1) and Section 8 (2) (f) require it to promote investment related education and training of all segments of the securities market; Section 8 (j) to compile, analyze and publish statistics relating to the financial activities of issuers of securities; and Section 8 (l) to carry out such research as may be required to implement the purposes of the Act and publishing information and data.

government “bailouts” make it imperative that retail investors understand the risks inherent in capital market products.

Tools available to the BSEC to expand its investor education program are its Annual Report, website and/or public statements (e.g., press releases, media communication, speeches, interviews and public discourse). The BSEC can use these tools more productively than previously to promote a better understanding of the capital markets and help to achieve a higher level of maturity. The BICM could be called upon to develop specialized training curricula and materials to promote the program.

6.1.3 Website

The BSEC website is the first place that most investors should look to find reliable impartial market information and an understanding of how the market works and their rights as investors. To do that, the website should be totally transformed including its organization, attractiveness and user friendliness. It should be upgraded to make it more accessible to users in Bangladesh and around the world. Its content should be extended to reach investor groups around the country. Website and program designers will find excellent models on the SEBI and Thai SEC websites <http://www.sec.or.th/education>. The SEBI website features a glossary of capital market terms, something BSEC should consider offering on its website.

6.1.4 Brochures

Brochures could be prepared on a wide variety of topics, e.g., “What every Investor Should Know,” “Understanding Risk”, “How to Select a Broker”, “How to Open a Brokerage Account”, “What to Look for in Your Statements from Your Broker”, “How to Diversify Your Portfolio”, “The Work of the BSEC”, and “What to Do if You Have a Question, Problem or Complaint?” These brochures could be made available at the BSEC and at each brokerage house as well as in electronic form on the BSEC website. In addition, copies can be made available at post offices and other places frequented by potential retail investors.

6.1.5 Media Relations

The BSEC's press release program should be enhanced and developed into a comprehensive “Media Relations” or “Public Affairs” program to provide background information and facilitate interviews and television appearances and policy discussions that increase the visibility and public understanding of the capital market and the role of the BSEC. The Chairman and other Commissioners and staff members could make presentations on hosted television or radio programs. The topics may be on issues of current interest, or more fundamental educational programs, such as “What is a Security”, “What are the Rights of a Security Holder”, “What is a Mutual Fund?, etc. BSEC

participation in programs would permit callers to present questions or issues to be answered live, on the air and would tend to enhance the BSEC's public image. Such community outreach activities/initiatives would not only educate and inform the public, they would also sensitize BSEC officials to issues of public concern.

Recommendation 16: The BSEC may wish to consider developing and implementing an expanded sustained investor education program that utilizes the BSEC website, brochures and media presentations to build an understanding of the capital markets among retail and institutional investors.

7 Organizational Challenges

As described earlier, CMDP II has helped to lay the foundation for a stronger more independent and efficient BSEC. This section addresses initiatives that build upon that foundation and realize the potential envisioned in CMDP II and BSEC's CMDMP. It focuses both on unfinished business (e.g. achieving “operational independence”⁷⁸) and on understanding and adapting to rapidly changing markets. The BSEC recognizes the overriding importance of its operational independence. In the CMDMP, BSEC states:

“The **independence** of the SEC is crucial to its ability to fulfill its public policy mandate. We recognize that the SEC must be free from political influence from a policy-making perspective, and it must be able to manage its own affairs from an administrative perspective. It is important that the Chairman of the SEC and its (Commissioners) are able to carry out their duties and responsibilities in the best interest of the investors and market. It is also important for the SEC to have financial independence, i.e. control its own operating budget.

Initiatives no. 9-12 (i.e., relating to amendments of Sections 3, 5 and 9 of the SEC Act) are intended to ensure the SEC's operational and financial independence. This is an IOSCO requirement, and is also widely recognized to be a *sine qua non* for effectively-regulated capital markets – a most crucial foundational building block in the absence of which an effective legal/regulatory framework cannot be established.

While recognizing the importance of *independence*, we note that it must be counterbalanced with *accountability*. A number of arrangements are already in place to ensure the SEC's *accountability* to the Government as well as the public at large. In summary, the SEC is accountable as a result of a requirement to produce (pursuant to Section 15 of the SEC Act) an Annual Report (to the Government and, through it, to the National

⁷⁸ IOSCO, Objectives and Principles of Securities Regulation, June 2010, Principle 2, “2 The regulator should be operationally independent and accountable in the exercise of its functions and powers.”

Assembly) and other reports that the Government may require from time to time, and because it is subject to a statutory audit by the Auditor General of Accounts under Section 128 of the Constitution.⁷⁹

This is consistent with IOSCO Core Principle 2.

7.1 Operational Independence – Delegated Procurement Authority

Amendments to the SEC Act provided BSEC with the autonomy to utilize its financial resources without prior government approval and raised the pay and benefits of its staff, permitting it greater discretion in hiring. However, because the BSEC is still subject to conducting its procurements through government facilities, it is unable to respond quickly to the needs and requirements of a dynamic organization. Government procurement processes can interfere with BSEC's planning and operations. Being subject to this requirement limits the BSEC's operational independence because it enables the government to limit or delay the BSEC's acquisition of the goods and services it needs to operate an effective regulatory agency. Ultimately, in the absence of BSEC procurement authority, government approval processes can disrupt BSEC's operations, introduce uncertainty and limit its effectiveness.

Delegated procurement authority would not exempt the BSEC from abiding by government procurement rules and regulations. Delegated procurement authority would mean that the BSEC would be able to conduct its own procurement, in full compliance with government procurement rules and regulations. Without such authority BSEC's effectiveness would be limited and it would not have the operational independence necessary to properly fulfill its mandate. One other government agency - Bangladesh Bank - has procurement authority. The BSEC, as a financial market regulator, should enjoy the same operating effectiveness as its counterpart.

Recommendation 17: The government may wish to consider authorizing the BSEC to conduct its own procurements with the proviso that, in conducting such procurements, BSEC will strictly adhere to government policies and procedures (i.e. delegated procurement authority) and that it will be held accountable for full compliance with government procurement rules and regulations.

Recommendation 23, below, that recommends the establishment of a BSEC Office of Internal Control and Compliance (or of Institutional Integrity), if adopted, should help to convince government authorities (i.e. at MOF and MPA) that there would be sufficient internal oversight mechanisms in place at the BSEC to deter, detect and prosecute misconduct, and should assuage any concerns over abuse of the procurement privilege.

⁷⁹Section 2.2.1 Independence of SEC, p.4

7.2 Operational Independence - BSEC's 10-yr Organogram

A further obstacle to BSEC operational independence is delay in the approval of its 10-year organogram. Under CMDP II, we recommended that the BSEC develop a long term operational plan that focuses on building a strong and independent professional and executive staff, on further insulating the BSEC from external political interference, and on transitioning the appointed Commissioners to more of a policy-making adjudicative role. In response, the BSEC has developed a long range plan that envisions a phased expansion of the BSEC to a staff of 620 by 2022, compared with its present staff of under 200. Among the 620 persons would be 396 Class 1 Professionals, or 206 more than the current 90 officers (including Commissioners).⁸⁰

The plan envisions a structure of 13 Divisions, each headed by an Executive Director, and 28 Departments. It includes an Office of Chief Accountant that consists of 52 employees, including 18 in an Accounting and Auditing Policies Department and 30 in a Corporate Finance Department. It also contemplates a 37 person Law Division, including 19 in a Legal Services Department. However, the proposed BSEC Organogram is still awaiting approval by the MPA and MOF. It is imperative that, in order for the BSEC to develop in an orderly way and to chart a phased plan for its incremental growth that the government approve the BSEC's (ten year) Organogram without further delay.

Recommendation 18: The government (MPA and MOF) may wish to consider approving the BSEC's (ten year) Organogram without further delay.

7.3 External Interference

The freedom of a securities market regulator from external interference is the fundamental starting point of the IOSCO Objectives and Principles of Securities Regulation. IOSCO's second principle states:

"The regulator should be operationally independent and accountable in the exercise of its functions and powers."⁸¹

The following guidance for assessing adherence to this principle is provided in IOSCO's Assessment Methodology:

"The regulator should be operationally independent from external political interference and from commercial, or other sectoral interests, in the exercise of its functions and powers."

⁸⁰ As of February 28, 2015.

⁸¹ Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, IOSCO, October, 2003, Page 14

Under CMDP II, we recommended the repeal of an earlier version of Section 16 of the SEC Act which permitted the government to give directions to the BSEC that it was bound to follow. Section 16 was amended in December, 2012 to permit the government to give the BSEC directions on policy matters which it is bound to follow. The amended clause adds a requirement that the government give the BSEC an opportunity to express its opinion on the issue of concern.

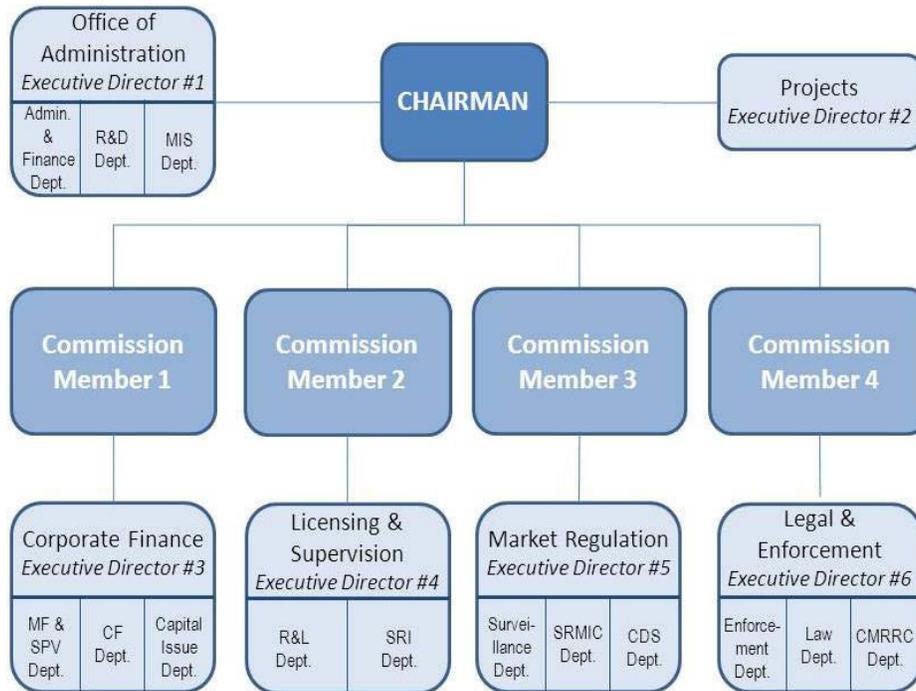
We believe that this provision, even as modified, inhibits the operational independence of the BSEC. In making decisions or taking actions, the BSEC must take into account that because of this provision its decisions may be “second guessed” -- reversed -- by the government. That can deter and restrain the BSEC from strict devotion to the fundamental principles that it espouses i.e., protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk.

Recommendation 19: The government may wish to consider giving serious consideration to repealing Section 16 of the SEC Act in order to limit the potential for direct external interference in the regulation of the capital markets.

7.4 Organizational Structure

Under CMDP II, we found the existing organizational structure of the BSEC fragmented and unwieldy to the extent that it separated authority and responsibility among different Commissioners for some closely related functions (e.g. CDBL and SRMIC; Law and Enforcement); and violated basic management principles by requiring 6 of 7 Executive Directors to report to two different Commissioners. We also commented on the disproportionate numbers of officers that reported to different Commissioners. We concluded that the structure hindered coordination and efficiency because different Commissioners had responsibility for related subjects. The CMDP II Master Plan envisioned the simplification and consolidation of BSEC's organizational structure including having each Executive Director report to only one Commissioner and the consolidation of related subjects. As shown in the organizational chart below, we envisioned a simplified structure of four departments, each headed by one of the four Commissioners: Corporate Finance; Licensing and Supervision; Market Regulation and Legal and Enforcement.

Figure 1 – Proposed Organization of the BSEC



Notes:

R&D – Research & Development
 MF & SPV – Mutual Fund & Special Purpose Vehicle
 CF – Corporate Finance
 SRMIC – Supervision & Regulation of Markets & Issuer Companies
 CMRRC – Capital Market Regulatory Reforms & Compliance

MIS – Management of Information System
 R&L – Registration & licensing
 SRI – Supervision & Regulation of Intermediaries
 CDS – Central Depository System

During the more than two years since we completed our work under CMDP II, there have been several realignments and reassignments of responsibilities at the BSEC. However, we have not been able to determine from its current organogram whether, or to what extent, the structure of the BSEC has been simplified, rationalized and made more coherent (in accordance with our recommendations).

Recommendation 20: To avoid fragmentation, strengthen accountability and improve efficiency, the BSEC may wish to consider reorganizing in accordance with the structure proposed in the organization chart above. Under it, each Executive Director would report to only one Commissioner, and each Commissioner would be responsible for all matters related to the area(s) assigned to him.

7.5 Long Term Planning

The BSEC and Bangladesh's capital markets have changed dramatically over the past two years. The BSEC has:

- Adopted and begun implementing a dynamic master plan;
- Gained a certain measure of financial autonomy/independence;
- Dramatically increased the effectiveness of its market surveillance capacity with the introduction of the Instant Watch Surveillance System;
- Become a signatory of the IOSCO Memorandum of Understanding which permits sharing of information with other signatories on enforcement matters; and
- Rapidly increased its size from 29 Officers in January 2012 to 90 in February 2015 (i.e., two-thirds of its officers are new) and will continue to grow as the market grows.

Equally dramatic changes have taken place and are taking place in Bangladesh's capital markets: the stock exchanges have demutualized; new financial instruments (e.g., asset backed securities, derivatives; expanded bond market, exchange traded funds and Sukuk) are contemplated, and the market infrastructure inevitably must become more efficient to accommodate the anticipated changes and support an efficient market.

As the BSEC increases its staff, builds its capacity and increases its competency over time, the BSEC's Commission should evolve into a deliberative policy-making and adjudicatory body. Its Executive Directors should become responsible for day-to-day management of its operations. To transition from what it is doing now to what it will be doing 10 years from now, the BSEC will need a road map that is anchored in a strategic plan. The strategic plan should enable the BSEC to more effectively oversee the expansion, financial and technological development of the market and its increasing complexity. It would not only help to more smoothly phase in the long term growth and restructuring of its staff, but would inform its technological transformation as well. Upgrading the BSEC's management information and electronic data gathering and retrieval systems starts with an understanding the BSEC's current and future needs. These should become clearer through the development of a strategic plan.

Recommendation 21: The BSEC may wish to consider developing a strategic plan to help it to identify and prioritize its strategic objectives, adopt goals and determine the activities and resources that will be needed to achieve its goals and objectives.

7.6 Integrating Information and Communications Technology (ICT)

The BSEC recognizes the need to modernize and transform its operations from paper-bound to more modern operations assisted by information and communications technology (ICT). Such a transformation will dramatically improve and vitalize/accelerate every phase of its operations from internal/external communications to how documents are filed, retrieved and analyzed. The process has already started with the

installation of its IWSS for surveillance of exchange trading. Immediate needs include electronic reporting by listed companies and intermediaries (i.e. an electronic data gathering and retrieval (EDGAR) system with appropriate interfaces and is compatible with the systems of relevant market institutions and professionals; a case tracking/management system for investigations; and enforcement cases and an internal communications system which BSEC recognizes is needed to transform its operations.

Considering BSEC's projected growth and the development of the market, it becomes immediately apparent that organizing, communicating with and managing the BSEC's rapidly growing professional and support staff and overseeing a complex capital market requires utilizing up-to-date modern technology to integrate the BSEC's various work streams, - i.e. information systems that can rapidly provide records and copies of filings to the investing public to dramatically increase the efficiency of the regulatory process and the market's transparency.

The BSEC has yet to devise a strategy and phased plan for refining and accomplishing its ICT goals. Any such plan begins with both ensuring extensive knowledge of the BSEC's current operations and a careful analysis of the BSEC's future needs taking into account the specific informational and automation needs and requirements of capital markets regulators in expanding markets such as Bangladesh's. Considering the size, scope and rapidity of the changes in the BSEC and the market, it is evident that the BSEC should begin as soon as possible to plan for the adoption and integration of information and communication technology that would enhance its effectiveness, accelerate its business processes, and improve its responsiveness through better internal and external communications. Annex 1 suggests a sequenced and phased approach that the BSEC may want to consider adopting in this regard. It also suggests basic principles for implementing a plan for the development of electronic systems for the BSEC.

Recommendation 22: The BSEC may wish to consider developing a sequenced and phased plan for integrating ICT into its organization. This may be suitable for consideration by the ADB as a Second Tranche Policy Action.

7.7 Institutional Integrity

One of the key challenges in Bangladesh is to restore the confidence of the investing public in the integrity of the capital markets. For its part, the BSEC must be beyond reproach. The present leadership of the BSEC has done a remarkable job of restoring the integrity of the BSEC. In its CMDMP the BSEC recognized the "crucial importance of the SEC's integrity assurance programs - i.e. the measures the SEC has in place for detecting and deterring misconduct by SEC Members and staff and the actions taken

to detect and deter such conduct – to the integrity of the markets and to the confidence of market participants.”⁸² The BSEC CMDMP states:

“The business of regulating the securities markets is complex and this complexity will only increase in the future as the market develops and becomes more diverse. These changes will also create new ethical challenges for the SEC. It is absolutely necessary that the SEC have a central set of guiding principles to act as a legal and ethical compass for its staff and Members. The present SEC Code of Conduct is incomplete. Therefore, we commit to undertaking a comprehensive Vulnerability Assessment (VA) to assess where the vulnerabilities for misconduct lie and the effectiveness of existing control mechanisms. Based on this assessment, a strategic analysis of the problem will be formulated and a range of programs will be identified and implemented to address the issue of integrity in a customized and effective way (i.e. a comprehensive Integrity Assurance Program).”⁸³

7.7.1 Vulnerability Assessment

As a first step to developing a comprehensive Integrity Assurance Program the BSEC may wish to consider undertaking a Vulnerability Assessment (VA) conducted by an experienced independent third party. This is rooted in both the recent experience of the BSEC and in the IOSCO Objectives and Principles of Securities Regulation, (IOSCO Principles). It is designed to counteract perceptions of the BSEC that resulted from the market collapse (i.e., that perceived failures of the BSEC contributed to it). The primary purpose of a VA would be to improve the BSEC’s ability to detect and prevent internal misconduct. In light of the BSEC’s experience and the resulting public perceptions of it, such an exercise could have a significant impact on market confidence. It would emphatically indicate the BSEC’s dedication to improving its own integrity and reputation and set an example for the rest of the market to follow.

This recommendation accords with the IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles). IOSCO Principle 5 states “*The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.*”⁸⁴ IOSCO suggests assessing compliance with Principle 5 in accordance with the following:

1. The staff of the regulator should observe the highest professional standards and be given clear guidance on matters of conduct including:

⁸² CMDMP, Section 2.2.10, p.12

⁸³ Id.

⁸⁴ Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, August 2013, p. 37 (Although this Principle refers to “staff,” it includes the Chairman and Members of the regulatory body).

- a. The avoidance of conflicts of interest (including the conditions under which staff may trade in securities).
- b. The appropriate use of information obtained in the course of the exercise of powers and the discharge of duties.
- c. The proper observance of confidentiality and secrecy provisions and the protection of personal data.
- d. The observance of procedural fairness.

2. Failure to meet standards of professional integrity should be subject to sanctions."⁸⁵

In assessing whether these standards have been met IOSCO suggests that any assessment consider the following key questions:

1. Are the staff of the regulator required to observe legal requirements or a "Code of Conduct" or other written guidance, pertaining to:
 - a. The avoidance of conflicts of interest?
 - b. Restrictions on the holding or trading in securities subject to the jurisdiction of the regulatory authority and/or requirements to disclose financial affairs or interests?
 - c. Appropriate use of information obtained in the course of the exercise of powers and the discharge of duties?
 - d. Observance of confidentiality and secrecy provisions and the protection of personal data?
 - e. Observance by staff of procedural fairness in performance of their functions?
2. Are there:
 - a. Processes to investigate and resolve allegations of violations of the above standards?
 - b. Legal or administrative sanctions for failing to adhere to these standards?"⁸⁶

IOSCO Principle 5 and related explanations should provide guidance both for conducting a VA and implementing the BSEC's comprehensive Internal Assurance Program.

⁸⁵ Id

⁸⁶ Id

7.7.2 Office of Internal Control and Compliance

We envision that the VA would establish the foundation for a comprehensive Integrity Assurance Program to be overseen by a permanent BSEC office. This office could, as suggested by the BSEC, be called the Office of Internal Control and Compliance (OICC). We would suggest the title "Office of Institutional Integrity" (OII) as it more precisely describes its role and is more closely aligned with the BSEC's goal of developing a comprehensive Integrity Assurance Plan. Broadly defined, this office, whatever it is named, would be responsible for ensuring accountability, integrity, and efficiency throughout the BSEC's operations. In addition to ensuring continuing rigorous compliance with IOSCO Principle 5, among other things, this office could hear, evaluate and, when appropriate, act on the complaints of investors and market participants.

It could also be instrumental in providing the GoB with reassurance that government procurement rules are being strictly followed if the BSEC is delegated procurement authority.

7.7.3 Code of Conduct

The BSEC's Code of Conduct should be the cornerstone of its comprehensive Integrity Assurance Program. The OICC/OII would be responsible for updating and strengthening it. To fully comply with IOSCO Principle 5, the Code of Conduct would be expected to restrict staff securities transactions; to ensure that they are properly reported; and that violations of any restrictions are strictly and impartially addressed. It should provide procedures for appropriate remedial and disciplinary actions for any improper conduct, and should clarify and provide appropriate guidance for avoiding conflicts of interest by, for example, establishing standards for:

- Enabling Commissioners to make independent determinations of any matters considered by the BSEC;
- Relationships with persons subject to regulation;
- Fiduciary relationships that could interfere with the proper performance of duties;
- Avoidance of personal business transactions or private arrangements for personal profit;
- Divulging or releasing any nonpublic BSEC document, or any information contained in any such document or any confidential information;
- Accepting host-paid travel or reimbursement;
- Outside employment and activities;
- Negotiations for future employment;

- Qualification to participate in particular matters that could involve the appearance of conflicts of interest or the impression of outside influence; and
- The kinds of activities that the staff may engage in after leaving the BSEC.

Recommendation 23: The BSEC may wish to consider undergoing a vulnerability assessment conducted by an independent third party and that it create a permanent BSEC Office responsible for:

- updating and strengthening the BSEC's Code of Conduct;
- responding to public complaints; and
- ensuring accountability, integrity and efficiency throughout the BSEC's operations including compliance with its Code of Conduct and all government regulations including procurement standards.

APPENDIX 2

MUTUAL FUNDS

APPENDIX 2 - Mutual Funds

1	Background	1
2	Recommendations to Encourage the Growth of Mutual Funds	2
2.1	Related Party Transactions	2
2.2	A Broadly Representative Industry Association	3
2.3	Repurchase Program for Closed-end Mutual Funds	5
2.4	Uniform Performance Measurement.....	9
2.5	Facilitating the Development of ETFs	11
2.6	Money Market Funds (MMFs)	17
2.7	Leveling the Playing Field	20
2.8	Enhanced Unit-holder Protections	22

APPENDIX 2 - Mutual Funds

1 Background

The BSEC Capital Market Development Master Plan (CMDMP) envisioned the adoption of a new legal/regulatory regime for mutual funds that would broaden participation, allow introduction of different types of mutual funds, strengthen investor protections, and eliminate preferential treatment of state sponsored mutual funds (including that these funds observe rules concerning conflicts of interest). It also called for establishing/strengthening an industry association to promote the development of the mutual fund industry.

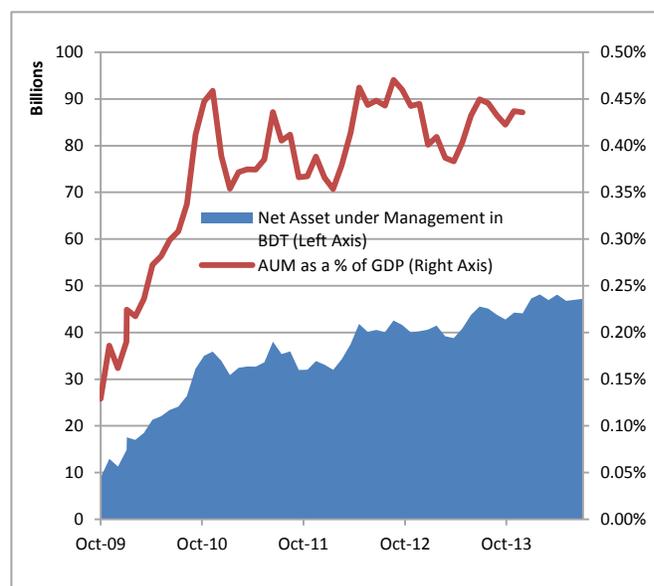
In the intervening two years the BSEC has adopted a number of significant changes to the Mutual Fund Rules, 2001, (MFR) consistent with measures proposed in the CMDMP. These include:

- Reducing the minimum required holdings of “capital market instruments” for mutual funds from 75% to 60%;
- Broadening the scope of the industry by permitting index funds and Shariah compliant funds;
- Permitting the reinvestment of dividends; and
- Electronic processing and dematerialized certificates for open-end funds

Since the beginning of 2011, the number of licensed Asset Management Companies (AMCs) has increased from 15 to 17 and the number of closed-end mutual funds has increased from 31 to 41. As shown in Figure 1, below, their assets under management (AUM) have grown from BDT 12 Billion in 2009 to BDT 49 Billion as of December 31, 2014.

The mutual fund industry is now able to operate more flexibly in the pursuit of its business opportunities. While it is still too early to evaluate the impact of the measures providing the industry with more avenues for growth, it can be observed that a number of new mutual funds have been launched during the

Figure 1 - Net Assets under Management (AUM)



span since CMPD II. Despite these positive steps the mutual fund industry is far from realizing its true potential. In comparison to other countries (both regionally and internationally), Bangladesh's mutual fund industry is still in a nascent stage of development.

2 Recommendations to Encourage the Growth of Mutual Funds

Reforms envisioned by CMDMP that have yet to have been implemented include:

- Measures to provide protections against self-dealing affiliated transactions;
- Establishing an effective mutual fund association that broadly represents the entire industry;
- Expanding the types of mutual funds;
- Adopting uniform performance measurement standards for mutual funds;
- Leveling the playing field by bringing all Investment Corporation of Bangladesh (ICB) funds under the same regulations as private sector funds;
- Introducing forward pricing and requiring updated prospectuses for open-end funds.

In addition to explaining why the need to implement these recommendations remains strong, we are recommending additional measures to enhance the attractiveness of funds: allowing tenders by closed-end funds to buy-in a portion of their units and adopting rules to permit ETF index funds and money market funds (MMFs).

2.1 Related Party Transactions

A mutual fund's susceptibility to self-dealing by its affiliated persons (related party transactions) is a central concern of mutual fund regulation. A related party transaction is one in which persons controlling; controlled by; or under common control with the AMC or affiliates of any of them are involved. The MFR rely on restrictions on relationships to control self-dealing by affiliated persons in related party transactions. That approach does not prevent an AMC from being related to another type of holding company or affiliate that could abuse a fund in related party "self-dealing" transactions. In CMDP II, we cautioned that the lack of a review mechanism to ensure the fairness of such transactions raised a fundamental regulatory concern. We suggested that although concerns over self-dealing, "related party" transactions can be dealt with in a number of effective ways *"...The best practice would be to require written advance third party (BSEC or trustee) approval and certification of the fairness and reasonableness of each such transaction based on a thorough analysis of it."*

Recommendation 1: To control self-dealing by affiliated persons in related party transactions, the BSEC may wish to consider amending the MFR to require written advance approval and certification of the fairness of each such proposed affiliated transaction by the fund's trustee.

2.2 A Broadly Representative Industry Association

Another goal envisioned under CMDP II and the CMDMP, with the potential for being of high impact, was “establishing a mutual fund industry association to, among other things, promote the development and professionalization of the industry.”¹ CMDMP called for assisting “the mutual fund industry in structuring and registering a mutual fund association.”²

In the interim since 2012, the *Association of Asset Management Companies and Mutual Funds* (AAMCMF) has been registered with the Ministry of Commerce. AAMCMF comprises four AMCs and the mutual funds associated with them.³ This includes the government owned ICB and ICB Asset Management Company, Ltd. (ICBAMC), a subsidiary of ICB, Race Management PLC and L-R Global Bangladesh AMC, Ltd., which together represent more than 80 percent of industry assets under management (AUM). Because AAMCMF does not include the rest of the 17 licensed asset management companies (AMCs), it does not broadly represent the interests of the entire industry. We consider membership of at least 75 percent of the AMCs to be broad representation.

Mutual fund industry associations in the USA [the Investment Company Institute (ICI)] and in India [the Association of Mutual Funds in India (AMFI)] have demonstrated that an effective, unified, well-resourced and well-managed mutual fund association can significantly support and develop a mutual fund industry: educate investors, sales and other professional market participants; develop the legal regulatory framework; train directors and trustees; raise industry standards and produce valuable economic research on the industry and the market.

A well-structured, effective, industry-wide fund association could play a significant role in promoting the growth of the mutual fund industry in Bangladesh. Among other things, in CMDP II we envisioned that such an association could sponsor a national campaign to educate the public about the advantages of long term investing and mutual funds. The need for such a campaign is more evident today. Mutual funds are not well understood and are under a cloud because the closed-end funds (which are the dominant type) are trading at deep discounts from their net asset values (NAVs). Lacking a broad consensus across the industry, the AAMCMF has been unable to build

¹ CMDMP, Section 2.5, p16

² TA-8512-BAN Interim Report, p.27

³ The non-members question the legitimacy of its registration on the ground that funds are not legal entities and therefore cannot be members of an association.

an effective, well-resourced program that can speak authoritatively on behalf of the industry on legal and regulatory matters and build greater acceptance of mutual funds.

Governance - Among the critical issues that divide the Bangladesh mutual fund industry (i.e., AMCs) is how an industry association should be governed (i.e., whether voting should be equally by AMC or should be weighted in some way to reflect AUM or the number of mutual funds managed). The governance structures of AMFI and the ICI, described below, though differing, are each broadly representative.

- **AMFI** - Only AMCs are members of AMFI and each has one equal vote (i.e., not related to AUM). However, AMFI's annual membership fee is stepped-up on a quantum or "slab" basis (i.e., 4 or 5 AUM size related slabs).
- **ICI** - Only mutual funds registered with the U.S. SEC may be members of the ICI. Under the ICI's Charter and By-laws, if one fund in a mutual fund complex becomes a member, each fund must become a member. Once the funds it advises become members, their investment adviser is considered a member of ICI. In the ICI, each fund has one equal vote. Thus, in effect, its investment manager's influence is increased proportionately to the number of funds it advises. ICI dues are based on AUM of each fund complex averaged over four quarters per year.⁴

We concur with the CMDMP's recognition of the importance of establishing an effective mutual fund industry association. Because the AMC's that currently comprise the industry are not likely unite to form a single association, we believe that the BSEC should help to bring the factions together by amending the MFR to condition licensing and relicensing of an AMC on its being a member of an association of AMCs that is broadly representative of the mutual fund industry (i.e. comprised of at least 75 percent of the licensed AMCs).⁵ A more unified, broadly representative mutual fund association is critical to establishing a well-resourced and well-managed association capable of promoting the development and professionalization of the entire fund industry.

Recommendation 2: To assist in the creation of a broadly representative, well-resourced mutual fund industry association, the BSEC may wish to consider amending Chapter 5 of the MFR, Asset Management Companies, Rule 27, Disqualification for granting registration, by adding a new sub-section (g) disqualifying any AMC that is not a member of a broadly representative industry association (i.e., represents at least 75 percent of licensed AMCs).

⁴ See ICI Brochure on benefits of membership and AMFI Website for models of the potential benefits of a well functioning and effective fund association. Source, telephone conversation with Michelle Kretch, Membership Director, ICI, 11/7/2014.

⁵ For first time applicants, the rule might provide a 60 day period from the date of issuance of a "provisional license" by which the applicant must become a member of such an association.

A Repurchase Program for Closed-end Mutual Funds – Deep discounts to NAV- The broad majority of mutual funds in Bangladesh are closed-end funds. They are listed and traded on the stock exchanges. As of December 31, 2014, there were 41 such closed-end funds with assets under management of roughly BDT 49 Billion. However, these funds have consistently sold at deep discounts from their net asset values (NAVs). We are informed that the weighted average discount at which closed end mutual funds are trading to their NAVs is 43.4 percent (ranging between 23.2 to 55.1 percent). These discounts discourage investors and threaten to curtail the growth of the mutual fund industry.

Maturing closed end funds - In view of the deep discounts at which closed-end mutual funds have been trading, the BSEC has reportedly been declining applications for extensions from maturing closed end mutual funds. Instead, it has called for them to either redeem all unitholders at NAV (minus allowable costs) or to convert to open-end mutual funds - a process commonly referred to as “open-ending”.⁶ This approach may prove to be counterproductive. To the extent that maturing closed-end funds choose to liquidate, the mutual fund industry may shrink, as it would be difficult to raise funds for a new closed-end fund in the present environment. This approach also raises concerns because either case – converting to an open-end fund or liquidating - creates an overhang, as the expectations of potentially large sales of those mutual funds’ investment portfolios loom on the horizon. We would suggest a more measured approach to dealing with the “discount problem”.

Opportunity - BSEC may wish to consider adopting a rule that would permit closed-end mutual funds to periodically repurchase a portion of their outstanding units at NAV through tender offers approved by their trustees and with full and proper disclosure. Such a program would permit tendering unit holders to realize immediate gains, could encourage additional investment in closed-end funds, and may promote interest in and development of closed-end funds without creating large overhangs. Because the size and timing of such tenders would be determined by the fund’s AMC and trustee (within parameters set by the BSEC) this approach would allow the AMCs and trustees flexibility to structure and time any tenders in order to minimize or avoid negative market impact.

Illustrative Example – Table 1 illustrates the potential effect of such a repurchase program on a hypothetical closed-end fund with 100,000 units outstanding, NAV per unit of BDT 100, and a market price per unit of BDT 50. For simplicity of calculations, it is assumed that the mutual fund has only one holding in its investment portfolio - 100,000 shares of a company valued at BDT 100 per share. Thus, the mutual fund’s market capital would be BDT 5,000,000 and its total NAV would be BDT 10,000,000 – i.e. it is trading at a 50% discount to NAV.

⁶ For more information, see. <http://shar.es/1fbWYR>

Table 1 – Illustrative Effect of Repurchase

	Pre-repurchase	Post-repurchase
Units Outstanding	100,000	90,000
NAV/Unit	100	100
Total NAV	10,000,000	9,000,000
Market Price/Unit	50	75
Total Market Capital	5,000,000	6,750,000
Discount to NAV	50%	25%
Units Repurchased	10,000	
Repurchase Price	100	
Cash Required	1,000,000	
Investment Portfolio		
Price per share	100	100
Shares Owned	100,000	90,000
Sale for Repurchase	10,000	
Management Fee	2.50%	2.50%
Total Mgmt Fee	250,000	225,000
Reduction in Fee		25,000
Percentage Reduction		10%

A reasonable expectation would be that a credible regular repurchase program, at NAV (BDT 100 per unit in the above example), could result in the market price of the units of such a mutual fund (depending on expectations concerning future repurchase offers, among other things) moving above BDT 50, and that, over time, this price would be likely to converge on BDT 100 per unit. In the above illustrative example, assuming that the market price would increase from BDT 50 to BDT 75 per unit, the discount would be reduced by 50% - i.e. from a discount of 50% to one of only 25%

Allowing a maturing closed-end fund the option of adopting a periodic repurchase program, rather than requiring it to redeem all of its outstanding units or to convert to an open-end fund, relieves the market overhang and downward market pressure that a redemption or open-end conversion would create. It also protects against shrinkage of the mutual fund industry. The prospect of tender offers at NAV could also help to improve how closed-end funds are viewed by investors. Because a periodic repurchase program at NAV would practically serve to support the price of a mutual fund's units (as a result of market expectations of periodic tender offers at NAV), the market price for such units is likely to increase, narrowing the discount to NAV. For these reasons we would suggest that the BSEC consider allowing closed-end funds to periodically repurchase portions of their outstanding units at their NAV.

Since total AUM would be reduced as a result of such repurchase programs (i.e. to pay for the periodic repurchases), advisory and other fees paid on the basis of average AUM would also be reduced. This, however, would be a better outcome for AMC's than the prospect of losing all fee income upon the redemption of a maturing closed end mutual fund. Converting to an open-end mutual fund ("open-ending") is not likely to be a realistic alternative for most of the maturing closed-end mutual funds, due to the absence of sufficient liquidity across asset classes.

For such a program to be effective, there are a number of considerations that AMC's and trustees would need to take into account in making such offers. Foremost is the need to maintain sufficient liquid investments that can be sold without negatively affecting the market price of these investments. A mutual fund contemplating a tender offer should be required to have 100% of the amount required to execute a contemplated repurchase in liquid assets/investments.

Regulatory steps - To allow for closed-end funds to implement repurchase programs, the BSEC may wish to consider adopting a rule that permits a closed-end fund to repurchase units from holders at NAV at periodic intervals, pursuant to repurchase offers made to all unit holders. Such a rule should, at a minimum:

- Define fundamental terms, including: "repurchase program", "tender offer", "tender", "tender deadline" (the date by which tenders must be received by the mutual fund or its agent); and "tender payment deadline" (the date by which the mutual fund must pay tendering unitholders for any units it repurchases);
- Require that the number of units subject to a tender offer be expressed in terms of the percentage of units outstanding on the tender deadline;
- Establish limits (*minimum and maximum*, expressed as percentages of outstanding units) that may be subject to a tender offer (e.g., not less than five percent nor more than 25 percent of the units outstanding on the tender deadline);
- Determine conditions under which the mutual fund would permit withdrawal or modifications of unit holders' tenders;
- Require that a mutual fund contemplating a tender offer have 100% of the amount required to execute the resulting repurchase in liquid assets/investments, and define the term "liquid assets/investments as those that can be sold or disposed of in the ordinary course of business at, or substantially close, to the price at which the mutual fund has valued such assets/investments, within a

period between the tender deadline and the repurchase payment deadline, or in assets/investments that mature by the repurchase payment deadline;

- Require that the mutual fund, its trustees and its AMC adopt written procedures reasonably designed, taking into account current market conditions and the fund's investment objectives, to ensure that the fund's investment portfolio and other assets are sufficiently liquid so that it can comply with its policy on tender offers and, in particular, the "liquidity requirement" mentioned in the previous bullet point;
- Prescribe the content and timing of a notice to unit holders advising them of the conditions of the tender offer, to include the tender offer amount (price and number of shares), applicable fees, the NAV per unit on the date the repurchase offer is made, relevant dates (e.g. tender and payment deadlines), procedures for unit holders to submit, modify or withdraw their tenders, circumstances under which the mutual fund may repurchase units tendered on a *pro rata* basis and/or other fair basis uniformly applied.⁷
- Require a mutual fund making a tender offer to pay tendering unit holders in cash by the tender deadline;
- Permit the mutual fund's AMC to deduct a fully disclosed repurchase fee from the tender offer price to compensate it for expenses directly related to the tender, and establish a cap for such fees expressed in terms of a percentage of the repurchase price (e.g., 2%).
- Prohibit the practice of conditioning tender offers on the tender of a minimum number of units by a single unit holder.
- Require that tender offers be pursuant to a fundamental repurchase policy adopted by the mutual fund's trustee, filed with BSEC, fully disclosed to investors, and changeable only by request of its trustee and with the consent of the BSEC.
- Require that this policy disclose the periodic intervals at which the mutual fund will make tender offers pursuant to the closed end mutual fund repurchase rule (as it may from time to time be amended), and the periodic interval between tender offers and tender deadlines or the means of determining them.
- Require that the mutual fund's Annual Report indicate the number of tender offers, if any, made during its fiscal year; the amount it offered to repurchase and the amount tendered with respect to each tender offer; and the extent to which

⁷ Whether the fund may purchase an additional amount of securities (and any additional limits); whether it will accept tenders from unit holders who own less than 100 units or those who tender all of their units; treatment of all or nothing tenders.

(if unit holders tendered more than the amount of the repurchase offer) the mutual fund:

- Repurchased any additional units;
- Repurchased units on a pro rata basis; or
- Accepted units tendered by unit holders who tendered all units held by them on an all or none or all or a minimum amount basis.

Recommendation 3: The BSEC may wish to consider adopting a rule to allow closed-end funds to periodically repurchase portions of their outstanding units at their NAV and permitting maturing funds, as an alternative to redemption or “open-ending”, to extend their maturity, in accordance with MFR requirements, with the proviso that they would implement a repurchase program.

2.3 Uniform Performance Measurement

Adoption by the BSEC of uniform performance measurement standards that include long term investment results could help to attract investors to mutual funds by expanding their perspective about fund performance and providing information about the advantages of investing in funds over the long term. Investors often rely on uniform performance measurements to compare funds with similar objectives, evaluate their management and prospects and make investment decisions based on comparable performance information over similar periods. The absence of such standards often invites manipulative and deceptive practices by AMCs. The BSEC may wish to consider requiring mutual funds to adhere to uniform measurement standards when providing information on the performance of the mutual funds operated by them.

IOSCO Performance Presentation Standards (PPS) - IOSCO has developed “Performance Presentation Standards for CIS: The Best Practice Standards” (PPS). The PPS includes nine basic principles, but can be summarized in just three:

- **Not misleading** - All advertisements by CIS, whether or not they contain performance information, should not contain any untrue statements of fact or omit to state any fact that is necessary in order to prevent the statements made, in the light of the circumstances in which they were made, from being misleading.
- **Viewpoint of average investor** - Performance information should be calculated and presented from the viewpoint of the average investor (i.e., investors to whom it is targeted).
- **Meaningful comparisons** - Performance information should be calculated in a substantially similar manner so that investors may make meaningful comparisons

among various mutual funds; and not be misled by differences in the method of calculation and presentation.

The nine PPS elaborate on and clarify these basic principles. To assure that advertisements are not misleading they should be: accompanied by any necessary explanations; consistent with the fund's prospectus; and provide balanced presentations (periods of good and bad returns and other relevant information).

To accommodate an average investor, performance information should reflect the deduction of all fees and expenses paid by each investor. Performance measurement should be based on standardized formulas that show the effect of fees and expenses paid indirectly and directly (sales and redemption fees) by the average investor. If such fees are not reflected, the fund should consistently use the same formula and prominently disclose the formula used and that actual returns were lower.

To be comparable, performance information must be presented for standardized time periods: a short term interval (e.g., one year) to show recent performance; longer term intervals (3, 5 and 10 years) to show volatility over time; and as of a recent date (e.g., end of most recent calendar quarter) to permit comparisons for the same time periods. Even then, if the information becomes stale, prominent disclosure should state that performance may be lower and direct investors to more current information. Because, where closed-end funds are traded on exchanges, performance may be calculated either as percentage changes in NAV or of their exchange traded values, advertisements must disclose which values are used and use them consistently.

Investors should be directed to additional information to evaluate a fund's performance and risks (e.g., narrative information about the market generally or a relevant performance benchmark such as an appropriate broad-based securities market index consistent with the fund's investment policies and objectives). A prominent disclaimer to the effect that "a fund's performance changes over time; past performance is not indicative of future results" should accompany all performance information.

Adoption of uniform performance measurement standards that accord with IOSCO PPS could help to create a better understanding of fund performance and volatility; allow investors to make more meaningful evaluations of fund performance over short and longer terms and vis a vis other comparable funds; and could potentially develop the mutual fund industry.

Recommendation 4: To encourage a better understanding of fund performance and volatility; allow more meaningful evaluations of fund performance over varying periods and versus other comparable funds; and to promote the development of the mutual fund industry, the BSEC may wish to consider requiring funds to provide uniform

measurement of their investment performance over designated periods as shall be determined in accordance with IOSCO PPS by rule of the BSEC.

2.4 Facilitating the Development of ETFs

Exchange Traded Funds (ETFs) are open-end mutual funds that list their units on an exchange and which trade throughout the day at market determined prices. Most seek to duplicate the performance of a selected index. While their units may be purchased on the open market, generally they are not redeemable from the ETF except in large blocks called *creation units* (i.e., blocks of ETF units as specified by the ETF) that an “authorized participant” (AP) can acquire or redeem, typically for a specified basket of securities or other assets.⁸ APs are entities (typically market makers, specialists or large institutional investors) authorized to create or redeem ETF shares in creation or redemption units.

ETFs originated in 1989 at the Toronto Stock Exchange (TSE) with the creation of the Toronto Index Participation Shares (TIPS) that tracked the TSE index by replicating its stock portfolio. Since that time, ETFs have evolved, growing in size and diversity and becoming increasingly popular. Their popularity traces to the fact that, unlike closed-end mutual funds, they sell at the approximate net asset value of their underlying investment portfolio; they are transparent; and they can play roles in active and passive investment strategies both for retail and institutional investors. Institutions may use ETFs for strategic or tactical purposes. For those subject to investment restrictions, ETFs can approximate futures or derivatives or can be used for short positions for hedge funds.

The DSE has announced that it is contemplating listing ETFs. The details of how those ETFs will be organized; the extent to which their operations would be facilitated through borrowing securities or use of derivatives; and whether authorized participants would need to meet certain qualifications have yet to be determined. However, as will be explained more fully below, Bangladesh does not currently have the necessary market participants (including strong long term institutional investors); legal and regulatory framework (transparency requirements; licensing program for APs; rules governing borrowing and lending of securities) to successfully establish and maintain an ETF industry.

At this stage, we can support the concept and recommend a program to develop an enabling environment for ETFs. Such a program would involve, as more fully explained below: training the staffs of the BSEC and stock exchanges on the operation and regulation of ETFs; drafting a rule and amending rules to ensure that, among other things, authorized participants are properly capitalized and the ETFs are fully transparent, properly valued and minimize tracking error.

⁸ Creation units are not affected when ETF shares are bought and sold on the market. Creation units can be bought and sold while the underlying portfolio securities in the trust account remain there.

2.4.1 Requirements for Establishing and Operating an ETF

Before considering the requirements for regulating ETFs, one must understand how they differ from other open-end mutual funds and the resources, participants and expertise necessary to successfully operate an ETF.

Creation - A simple example illustrates the procedures required to establish an ETF. First, an AMC looking to establish an ETF files an application with the BSEC. Upon approval, the AMC enters an agreement with an AP. An AP borrows securities from an institutional investor and places them in a trust. These securities are used as the basis for ETF "creation units." The ETF's units are legal claims on the portfolio of securities held in the trust. Swapping portfolio securities for ETF units is an in-kind trade that should have no tax implications.

Sales or exchanges of ETF units - APs, the key players, are the financial institutions that purchase and redeem ETF units directly from the ETF. After purchasing a creation unit, the AP may hold or sell some or all of the ETF units in exchange transactions. The redemption process is the reverse. An AP purchases the number of ETF units that comprise a creation unit, and redeems it in exchange for a "*redemption basket*" (a pro rata portion of the ETF's underlying investment portfolio). Investors can "redeem" their ETF units either by selling them on the exchange (individual investors) or, those with sufficient resources who are able to assemble enough ETF units to form a creation unit, redeem them "in-kind" for a pro-rata share of the ETF's investment portfolio. Because of the large number of ETF units required to form a creation unit, only institutional investors are likely to be able to avail of this means of redemption.

Supply and demand equilibrium - For an ETF to deliver its defining benefit, trading at or near its NAV, APs (arbitrageurs) must maintain equilibrium between the supply and demand for EFT units. Arbitrageurs profit from price discrepancies, whether above or below the NAV of the ETF. When an ETF's units are trading at a premium, APs buy the underlying securities, exchange them for creation units, and sell ETF units on the open market at a profit. When an ETF's units are trading at a discount, APs buy sufficient ETF units on the open market to form creation units, exchange them for the underlying securities; and sell these securities on the market at a profit.

Transparency – Transparency is the key factor that allows the market price of ETF units to track their NAV, as it permits APs to discover price discrepancies and engage in arbitraging. Thus, AMCs must disclose the value of an ETF's underlying investment portfolio securities frequently during the trading day.

Degrees of complexity - ETFs can be categorized into roughly two structures: physical and synthetic ETFs with further variations and increased complexity resulting from leveraging, creating inverse ETFs and actively managed ETFs.

- **Physical ETFs** replicate an index by reconstituting or sampling the basket of securities underlying the index with appropriate weighting. They directly or indirectly hold all or most of the securities underlying a particular benchmark index. They are highly transparent because their portfolio composition is regularly and publicly disclosed and the underlying index can be easily followed. ETF's also may be based on an index designed specifically for them.
- **Synthetic ETFs** achieve their investment objectives by entering an asset swap (e.g., an O-T-C derivative) with a counterparty or by using futures or options.
- **Leveraged and inverse ETFs** - Additional complexity and risk are introduced by an evolving variety of ETFs that seek to provide unit holders with magnified exposure to a particular stock, bond or commodity index ("leveraged ETFs"), and by ETFs that seek to produce the opposite return of a particular stock, bond or commodity index ("inverse ETFs"). Inverse ETFs may also be leveraged.
- **Actively managed ETFs** - Another form of ETF, an "*actively managed ETF*," is one that does not seek to track a market index, but is a unique mix of customized investments that trades securities at its discretion to meet its investment objective and policy.

2.4.2 Bangladesh's Readiness for ETFs

In emerging markets, ETFs typically track broad based indexes because the stocks that comprise such indexes are the only ones likely to have sufficiently liquidity to maintain parity with the indexes they track. We suggest that Bangladesh focus first on establishing ETFs that track existing broad based well-known indexes. To the extent that the securities that make up the indexes are familiar and their components are stable, they present the fewest impediments and would be the logical starting point for an ETF industry. Eventually, over time, a more broadly varied ETF industry could be expected to evolve (e.g., ETFs that track a wide range of securities, industries and averages: bonds, drug companies, garment manufacturers, banks, exchange rates and housing).

Key elements that must be developed for the successful introduction of ETFs in Bangladesh include:

A large base of financially sound institutional investors - to support ETFs. There must be deep pools of securities held for the long term by institutional investors (e.g., pension funds and insurance companies whose investment strategies involve investing in and holding large amounts of securities over the long term) and a sufficient number of well-resourced well-qualified entities, financially sound brokers and investment bankers. Together they would provide the financial resources, sophistication and expertise to serve as APs, and through taking advantage of arbitrage opportunities, provide the

supply and demand equilibrium to maintain the market price of ETF units at or near their NAVs.

The legal and regulatory framework - already includes the MFR that regulates mutual funds and rules for listing and trading securities on stock exchanges. These must be adapted and supplemented to accommodate the characteristics and risks of ETFs and their supporting entities, without sacrificing the fundamental protections they provide. Among other things, the regulatory framework should include certification and licensing of APs and ETF AMCs. Rules should also define the manner by which “tracking error” (how consistently an index based ETF follows its benchmark reference index) is measured and disclosed and establish parameters for the magnitude of acceptable tracking error.⁹ As ETFs develop, additional rules may need to be adopted that permit borrowing and lending of securities, short selling and the use of derivatives. Fortunately, an appropriate legal and regulatory framework need not be invented from scratch. IOSCO has developed the basics of a program for regulation of ETFs, i.e., IOSCO Principles for regulation of ETF's, which should provide the starting point for structuring a legal and regulatory framework for ETFs in Bangladesh.¹⁰

IOSCO Principles for regulation of ETF's - IOSCO recommends nine principles for the regulation of ETF's In short, it recommends:

- Requiring disclosures that help investors to clearly differentiate ETFs from other Exchange Traded Products (ETPs);
- Ensuring a clear differentiation between ETFs and other mutual funds, as well as appropriate disclosure for index-based and non index-based ETFs;
- Requiring appropriate disclosure with respect to the manner in which an index-based ETF will track the index it references;
- Transparency regarding an ETF's portfolio and/or other appropriate measures in order to provide adequate information concerning any index referenced and its composition; and the operation of performance tracking;
- Disclosure of fees and expenses for investing in ETFs to permit investors to make informed decisions about whether they wish to accept a particular level of costs and invest in an ETF;

⁹ Tracking error measures how consistently an index-based ETF follows its benchmark underlying reference index. Tracking error is defined as the volatility (as measured by standard deviation) of the differences in returns between a fund and its underlying reference index. Tracking error helps measure how well the ETF tracks its referenced index.

¹⁰ “Principles for the Regulation of Exchange Traded Funds, Final Report,” Board of IOSCO, June, 2013

- Disclosure requirements that enhance the transparency of information available with respect to the material lending and borrowing of securities (e.g., on related costs);

Requiring all ETFs, in particular those that use or intend to use more complex investment strategies, to assess the accuracy and completeness of their disclosure, including whether it is presented in an understandable manner and addresses the nature of the risks associated with the ETFs' strategies;

- Ensuring that the securities laws and applicable rules of securities exchanges appropriately address potential conflicts of interests raised by ETFs; and
- Ensuring that ETFs appropriately address risks raised by counterparty exposure and collateral management.

Looking to the future - To enable ETFs to realize their full potential the industry would need to expand to offer more complex ETFs and become more varied. This would require a strengthened market infrastructure that provides rapid and seamless clearing and settlement mechanisms (i.e., a central counterparty for derivatives; a commodities and futures exchange for trading commodities and futures). For ETFs to become even more useful, a means of valuing a wider variety of less liquid assets and tracking investments would be needed.

2.4.3 Measures to Support the Development of ETFs

The path to an ETF industry begins with a feasible plan that identifies achievable milestones. This must begin with an understanding by key market participants - including the BSEC and the exchanges - of how the instrument works, its benefits and risks, and how it should be regulated. An appropriate incentive structure would ensure that market participants have the proper incentives to participate in and develop the ETF market. This would include an understanding of how ETF's can help them to achieve their goals and what their roles would be. The BSEC and the exchanges must be prepared to address the regulatory challenges presented by ETFs. AMCs and broker-dealers will play key roles. Retail and institutional investors should understand how ETFs differ from other open and closed-end mutual funds; and the costs, expenses and risks involved in dealing in and owning them.

The following milestones outline a possible roadmap for introducing ETFs in Bangladesh.

- The existing legal and regulatory structure (laws and regulations administered by the BSEC, exchange rules and procedures, as well as those of the CDBL) are reviewed and amendments and exemptions necessary to accommodate the expected early ETFs which would track major indexes are proposed. The

objective of this milestone would be to ensure fundamental protections to investors under existing laws while accommodating the smooth operation of ETFs through amendments and exemptions that would permit ETFs to track the indexes they reference. This exercise would focus heavily on:

- Disclosure;
 - Qualification requirements for sales personnel;
 - Fair sales literature;
 - Suitability standards and compliance;
 - Transparency requirements [the components of the ETFs portfolio, the ETFs intraday investment value (IIV) and measurement of tracking error]; and permissible tracking differences;¹¹
 - Training enforcement staffs of the BSEC and the exchanges in ensuring that the operations of ETFs are fully transparent.
- Licensing standards for APs and other intermediaries who would play key roles in the operation of ETFs are established by rules. Critical decisions involve who may be an AP; the financial adequacy of APs; training, skills, knowledge and certification of licensees; including requiring them to demonstrate expertise before being licensed.
 - Key players are trained in the potential of ETFs; their operation and the roles they can play in their development.
 - Deep long term investment pools are developed by institutional investors and interest is generated among them on how ETFs could be useful in meeting their long term goals and objectives. Achievement of this milestone could be measured by the number of such institutional investors that apply and are licensed as APs.
 - An ETF that tracks an established index is licensed, along with its AMC and APs, and begins operating within acceptable parameters of tracking error and tracking differences.
 - After a period of successful operation of the initial index tracking ETF (or ETFs), the legal and regulatory framework is broadened to accommodate more divergent and complex ETFs. Possible initiatives could include provisions for short selling,

¹¹ Tracking difference measures the actual under-or outperformance of the fund compared to the underlying reference index. Tracking difference is defined as the total return difference between a fund and its underlying reference index over a certain period of time.

borrowing and lending securities, leveraged and inverse ETFs and actively managed ETFs.

- Rules are amended and supplemented to permit synthetic ETFs that achieve results through the use of swaps, short sales, derivatives and futures. These would require higher licensing and certification standards and refocusing disclosures and regulations on inherent conflicts of interest and counterparty risk.
- Actively managed ETFs are licensed and the focus on enforcing transparency of their portfolios and IIVs is intensified.

Recommendation 5: The BSEC may wish to consider adopting rules to facilitate the introduction of ETFs that track an established index. These rules would include: disclosure, licensing and qualification of APs and AMCs, fairness of sales literature, suitability, and various transparency requirements (the components of the ETFs portfolio, the valuation of ETFs and measurement of tracking error). The BSEC, the exchanges and potential professional participants would need training on the regulation and operation of such ETFs.

2.5 Money Market Funds (MMFs)

A money market fund (MMF) has been defined by IOSCO “as an investment fund that has the objective to provide investors with preservation of capital and daily liquidity, and that seeks to achieve that objective by investing in a diversified portfolio of high-quality, low duration fixed-income instruments.”¹²

Popularity - Globally, MMFs have accumulated impressive sums and represent a significant portion of total mutual fund assets. The ICI reported US MMF assets of \$2.69 Trillion as of February 5, 2015. In its report on MMFs (Consultation Report), IOSCO estimated that MMFs comprised approximately 20 percent of the assets of investment funds globally. U.S. and European MMFs accounted for 90 percent of the then \$4.7 trillion global MMF industry.¹³ The popularity of MMFs can be attributed to their usefulness to both retail and Institutional investors. MMFs provide a highly liquid means to easily diversify cash management and credit risk exposure while providing borrowers access to short term funding. Because of their wide appeal, MMFs generate interest in and spur broader industry growth and offer a convenient path to investment in conventional open-end funds. Moreover, in the US and Europe, MMFs provide a significant source of financing for governments, business and financial institutions.

¹² “Money Market Fund Systemic Risk Analysis and Reform Options,” (Consultation Report), Technical Committee of IOSCO, 27 April 2012, p.1.

¹³ Id.

Challenges to development of MMFs - The successful development of money market funds requires careful attention to a number of difficult regulatory issues: valuation, definitions of instruments that qualify for investment by MMFs, term (duration) of instruments).¹⁴ MMFs, as important sources of short-term funding (particularly for banks), have been considered by the Financial Stability Board (FSB) to be part of a “shadow banking system.”

2.5.1 Bangladesh’s Readiness for MMFs

In Bangladesh, the MFR would apply broadly with respect to the structure of MMFs. However, the MFR would need to be amended and a separate *Schedule* adopted with respect to the diversification and the types of investments a MMF could hold (e.g., modify requirements to own exchange traded securities). Special emphasis would need to be placed on the duration and valuation of the various types of instruments an MMF could hold. The BSEC would need to coordinate closely with Bangladesh Bank (BB) and other stakeholders with respect to the potential impact of the introduction MMFs on the banking system. Attention would also need to be directed to whether there would be sufficient amounts and varieties of short term instruments to support MMFs. The BSEC should also consider whether and/or how credit rating agencies (CRAs) might assist in the valuation of the instruments held by MMFs. Additional training for regulators, fund operators, trustees and brokers would also be required. The investing public would need to be educated about the uses of MMFs and how they differ from other mutual funds.

IOSCO Recommendations - The regulatory framework would need to take into account IOSCO’s recent recommendations to limit systemic risk.¹⁵ Those recommendations can be broadly summarized as follows:

General recommendations

- MMFs should be defined separately in mutual fund regulations.
- Specific limitations should apply to the types of holdings/portfolios in which MMFs may invest and the risks they may take.
- The development and use of other vehicles similar to MMFs (e.g., mutual funds or other types of securities) should be closely monitored by regulators.

Recommendations regarding valuation

¹⁴ The IOSCO Consultation report was also concerned with possible systemic risks related to fixed price MMFs. Those risks foreclose any possibility of creating a fixed price MMF in Bangladesh.

¹⁵ IOSCO, Consultation Report, April 2012,

- In valuing the securities (instruments) held in their portfolios, MMFs should comply with the general principle of fair value. The amortized cost method should be used in limited circumstances only.
- MMF valuation practices should be reviewed by a third party (e.g., auditor) as part of periodic reviews of the funds' accounts.

Recommendations regarding liquidity management

- MMFs should establish sound policies and procedures to know their investors, including their liquidity preferences.
- MMFs should hold a sufficient amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales.
- MMFs should periodically conduct appropriate stress testing.
- MMFs should have procedures in place to deal with exceptional market conditions and substantial redemption pressures.

Recommendations regarding the use of ratings

- MMF regulation should strengthen the obligations of responsible parties regarding internal credit risk assessment practices and should avoid any mechanistic reliance on external ratings.
- CRA supervisors should seek to ensure that CRAs make more explicit their current rating methodologies for MMFs.

Recommendations regarding disclosure to investors

- MMF documentation should include a specific disclosure drawing investors' attention to the absence of a capital guarantee and the possibility of principal loss.
- MMFs' disclosure should include all necessary information regarding the fund's practices relative to valuation and the applicable procedures in times of stress.

Recommendations regarding MMFs' practices in relation to repos

- When necessary, regulators should develop guidelines strengthening the framework applicable to the use of repos by money market funds, taking into account the outcome of current work on repo markets.

Recommendation 6: As a first step in developing MMFs, the BSEC may wish to consider inviting the BB and major stakeholders (banks, AMCs, etc) to discuss the benefits and

challenges of introducing MMFs in Bangladesh. Upon developing a positive consensus, the BSEC might wish to consider amending the MFR and drafting a separate MMF rule that accords with the IOSCO MMF recommendations.

2.6 Leveling the Playing Field

ICB, a government entity, serves as trustee for more than twenty ICB mutual funds for which it or its subsidiaries act as their AMC and/or broker. ICB, through its subsidiary, ICB Capital Management, Ltd., (ICBCML), also serves as trustee for at least seven non-ICB funds. These arrangements, because of the conflicts of interest they present, deprive a large segment of mutual fund investors of the principal protection contemplated by the MFR and by the IOSCO Principles for CIS (Mutual Funds), an independent oversight entity, i.e., an independent trustee. They also create a two tiered regulatory structure for the mutual fund industry, between government owned and private sector owned AMCs that distorts the market. We therefore reassert the CMDMP's recommendation to *"eliminate preferential treatment of state-sponsored mutual funds to remove distortions and create a level playing field between state-owned and private sector asset management companies."*¹⁶

The unique privileges and competitive advantages enjoyed by ICB are understandable only as an historical anomaly. ICB was established by the Investment Corporation of Bangladesh Ordinance, 1976 (ICB Ordinance), Ordinance No. XL of 1976. ICB organized Bangladesh's first mutual funds and until March 2000, when the first private sector mutual fund was launched, managed the only mutual funds in Bangladesh. Prior to the adoption of the MFR, ICB, or its subsidiaries, had served as trustee, custodian, AMC and securities dealer for its funds. When the MFR was adopted, although it banned such relationships, the BSEC granted ICB exemptions that allowed it to continue to operate under the pre-existing arrangements, as AMC as well as the trustee, custodian and broker of the ICB funds, and subsequently to serve as trustee for other funds (e.g., RACE).

IOSCO Principles of Governance of CIS (i. e., Mutual Funds) - The global standards for protection of mutual fund investors formulated by the Technical Committee of IOSCO (Committee) states that "Member jurisdictions agree that, as a primary principle, CIS Governance must provide for independent review and oversight of the organization and operation of the CIS."¹⁷ It defined Independence as *"a set of arrangements that provide Independent Entities with appropriate legal conditions and autonomy to exercise their powers and functions without constraints or interferences from the CIS Operator or its related parties, and allow adequate and objective oversight of the CIS"*

¹⁶ BSEC Master Plan, 2012, p.16.

¹⁷ EXAMINATION OF GOVERNANCE FOR COLLECTIVE INVESTMENT SCHEMES, Part I, FINAL REPORT, June 2006, p.10. (IOSCO PD 219)

and CIS Operator's activities, with the objective of protecting CIS Investors and their assets".¹⁸ These arrangements include:

- "The Independent Oversight Entities (IOEs) should be set up, composed, appointed or dismissed under conditions that prevent the decision making process from being tainted by any type of conflicts of interests with the CIS Operator and its related parties.¹⁹
- The organization and the practical functioning of the IOEs should allow them to be out of the control or undue influence of the management of the CIS Operator or its related parties.²⁰
- There should not be any confusion between responsibilities of the IOEs when exercising their oversight function on the one side and the CIS Operator in its asset management role over the CIS on the other side."²¹

These principles are applicable to all mutual funds. The report stated that the Principles should allow the oversight entities to be independent in all cases.

In Bangladesh, the MFR provide trustees broad oversight powers to enable them to carry out their responsibilities. The responsibilities of the trustee, as set forth in MFR Rule 24, are fundamental to the protection of unit holders. If a trustee believes that a fund is not being managed properly, it must take action to protect unit holders and inform the BSEC.²²

To avoid conflicts of interest and promote trustee independence (and in accord with IOSCO Principles), Rule 19 (1), relating to disqualification of a trustee, establishes a strict standard requiring trustee independence from other entities and directors that conduct mutual fund operations. It restricts the BSEC from registering (licensing) a trustee if the trustee or any of its directors are related to the fund's sponsor, AMC, stock broker or stock dealer, portfolio manager or merchant banker, is the director of any such company or organization or any company under any of them or is in some way related to them. Because ICB or its subsidiaries serve as the AMC and stock broker for the ICB funds, the Rule 19 prohibition would prevent ICB from serving as trustee of any fund (including any non-ICB mutual fund (e.g., Race) as long as it is serves as an AMC, stock dealer, stock broker or portfolio manager, or was in some way related to one of them.

¹⁸ February 2007, at pp.4, 5. (IOSCO PD 237)

¹⁹ Id, p. 5

²⁰ Id, p.7.

²¹ Id, p.8

²² MFR Rule 24(2), 2) "If any Trustee any time thinks that activities of the Mutual fund is not being carried out as per concerned act or these rules, the Trustee will then and there take necessary steps to rectify the situation and will inform the Commission (BSEC) regarding that."

Exemptions - Despite the MFR's clear trustee independence requirements, Sub-Section 2 of Rule 19 permits the SEC "for public interest" to relax any provision under sub-rule 1. MFR Rule 23 is even more explicit with respect to the appointment and disqualification of a Trustee. It prohibits the appointment of a trustee that is under the control of, or an associate of, a sponsor or AMC, but also permits the BSEC to relax this condition in the case of any trustee for "public interest." Rule 27 d) relating to registration of AMCs contains a parallel disqualification provision. It prevents the BSEC from registering an AMC if it or any of its directors are related to a trustee. However, as in Rules 19 and 23, sub-section 2 of Rule 27 permits the BSEC to relax that provision if it finds it in the "public interest."

Because the BSEC has relaxed these provisions and granted exemptions with respect to ICB and ICBAMC, ICB (either directly, or through its subsidiaries) serves as trustee for most Bangladesh mutual funds. Those funds account for over sixty percent of Bangladesh's mutual fund market share. As a result, in Bangladesh, a significant number of unit holders do not receive the critical independent trustee protections envisioned under the MFR. By exempting ICB and its subsidiaries, the BSEC has nullified the primary unit holder protection required by the MFR and IOSCO Principles.

We support the BSEC's commitment to eliminating preferential treatment of state-sponsored mutual funds explicitly stated in CMDMP Initiative 60, *i.e.*, "Require ICB Funds to comply with mutual fund rules concerning conflicts of interest."²³ In accordance with IOSCO Principles, the BSEC may wish to consider rescinding exemptions that permit ICB or its subsidiaries to act as trustee for ICB's or any other mutual funds. If the BSEC were to maintain a level playing field, ICBAMC would also be independent of the ICB Securities Trading Company, Ltd. (or any other ICB stock broker) or the MFR would be revised to permit all AMC's to be affiliated with stock brokers and dealers.

Recommendation 7: The BSEC may wish to consider withdrawing exemptions granted to ICB and its subsidiaries and requiring them to comply fully with MFR rules relating to conflicts of interest.

2.7 Enhanced Unit-holder Protections

To increase investor protections and facilitate the sale of open-end funds, we would suggest that the BSEC consider the adoption of the IOSCO standard of forward pricing for open-end funds, which would eliminate opportunities for arbitrage against the mutual fund, and requiring annual updating of prospectuses for open-end funds.

²³ CMDMP, Table 5, p.17

Recommendation 8 - The BSEC may wish to consider amending the MFR to require forward pricing for purchases and redemptions of open-end fund units and require that they be priced not less often than weekly.

Recommendation 9 - The BSEC may wish to consider amending the MFR to require open-end funds that make a continuous offering of units or reinvest dividends in units to update their prospectuses at least annually.

APPENDIX 3

BOND MARKET DEVELOPMENT

APPENDIX 3: Bond Market Development

1	Bond Market Development Critical to Reducing Crowding Out.....	1
1.1	The Importance of Bond Markets in Infrastructure Finance	3
1.2	Structural Problems in the Bangladesh Government Bond Market.....	4
1.2.1	Overreliance on Banks and National Savings.....	4
1.2.2	Mismatch in Maturity Profile.....	6
1.2.3	Lack of Credible Yield Curve	8
1.2.4	Devolvement:	9
1.2.5	Absence of Short Selling:	9
1.3	Bangladesh Government Bond Market Reform Strategy	9
1.4	Primary Dealer System and Debt Management.....	10
1.5	Primary Dealer Reform - Key Recommendations.....	14
1.6	The Importance of Allowing Short Selling	16
1.7	Developing the Foreign Investor Base.....	17
1.8	Developing the Local Investor Base	18
1.8.1	Measures to Help Stimulate Development of the Insurance Industry	18
1.8.2	Measures to Help Stimulate Development of the Pensions Industry.....	19
1.8.3	Catalyzing the Growth of Bond Mutual Funds.....	19
1.8.4	Tax Benefit of Mutual Fund Investors / Unit Holders:	21
1.8.5	Encouraging Greater Retail Distribution of BGBs	21
1.9	Conclusions – A Bond Reform Roadmap	22
2	Corporate Bond Markets.....	27
2.1	The Importance of a Corporate Bond Market	27
2.2	Requirements for a Corporate Bond Market	28
2.3	Improvements in the Regulatory Framework for Issuing Corporate Bonds.....	30
2.3.1	Non-Convert Debt Issue for Private Placement: Debt Private Placement Rules (Appendix 2A)	31
2.3.2	Rules Governing the Private Issuance of Convertible Debt	33
2.3.3	Rules Governing the Issuance of Preference Shares: Above equity related rules.....	33
2.4	Policy Actions for Corporate Bond Issuance	34
3	Issuance of.....	35

Foreign Currency Denominated Debt	35
3.1 A New Regulatory Framework for Foreign Currency Corporate Bond Issuance	36
3.1.1 Lessons from Indian ECB Borrowing Rules	36
3.2 Policy Recommendations for Foreign Currency Bonds	38
4 Conclusions – Why has corporate bond market development been so slow?	40

APPENDIX 3: Bond Market Development

Bond Market Development Critical to Reducing Crowding Out

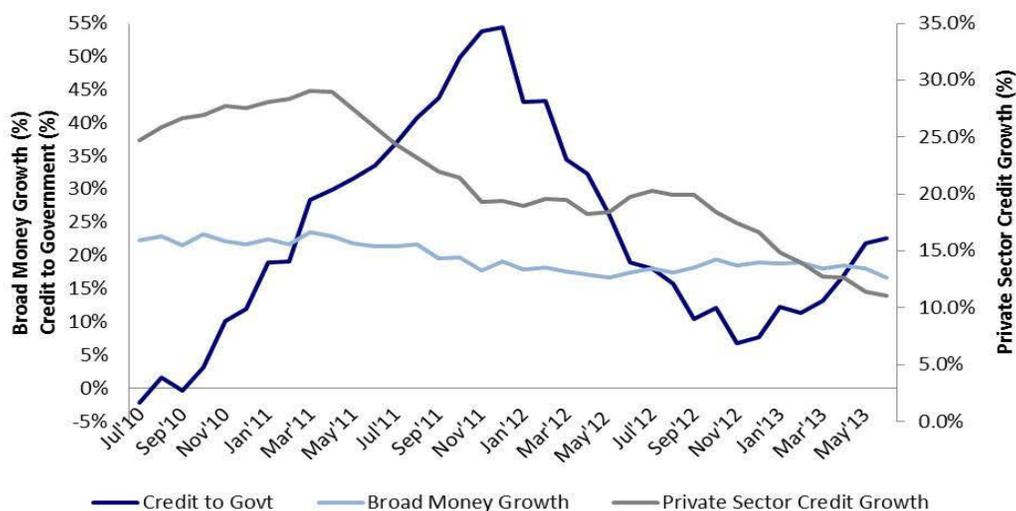
Bond markets are central to the development of an efficient economic system. The most fundamental reason is that they help to finance either the government budget deficit or corporate financing/investment needs in a cost-effective manner and are, thus, essential to the efficient allocation of capital. In addition, bond markets make financial markets more complete by generating market interest rates that reflect the opportunity cost of funds at a wide range of maturities. This is essential for efficient investment and financing decisions.

A second reason is that the development of bond markets can avoid concentrating intermediation on banks. It is better to spread some corporate risk in capital markets than to concentrate *all* corporate risk in the banking system.

In the specific case of Bangladesh, the need for a developed bond market to meet both government and corporate financing needs has been amply illustrated by the massive public sector crowding out of the private sector seen in FY 2011/12.

This is illustrated in the first chart below which shows credit to the government was the fastest growing element of money supply growth over that period. A major cause behind the rise in the budget deficit was the loss at Government Corporations involved in the energy sector, most notably the BPDB and BPC.

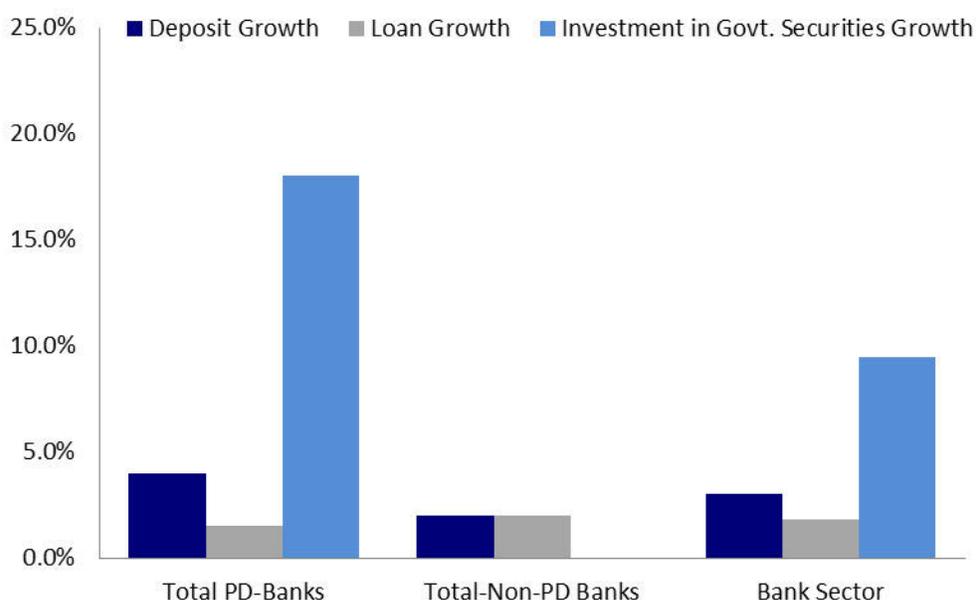
Figure 1 – Growth of Monetary Indicators



Source: AT Capital Research

The significant deterioration in the government deficit in that period was increasingly financed by the banking sector as illustrated in the chart below. This put increased pressure on banks given the liquidity squeeze in a tightening monetary policy environment and also compressed margins for primary dealers given that the yield on government debt was substantially below corporate or household lending rates and in fact below deposit rates a number of banks have had to pay given the competition for funds. Although the government has recognized the need to reduce the crowding out of the banking sector, a number of variables remain outside its control such as the trends in global energy prices and the ability to secure international financing such as the IMF facility and greater foreign aid disbursement.

Figure 2 – Growth (Quarter 2 to Quarter 3, 2011)



Source: PRI Staff Estimates

The absence of a well-developed government bond market was a primary contributor of the public sector crowding out that had a significant negative impact of private sector investment growth as many companies postponed capex decisions in the face of reduced access to bank finance. In addition, domestic market rates soared with FDR rates of more than 15% and lending rates at 18-20% given the liquidity crisis.

The absence of a developed domestic corporate bond market imposed a double blow on the private sector as they had no alternative financing options. The reduction in investment spending undoubtedly reduced both current and future potential growth rates of the Bangladesh economy.

1.1 The Importance of Bond Markets in Infrastructure Finance

It has been estimated by the World Bank among others that Bangladesh needs to invest \$ 7-10 bn in Infrastructure annually. There is an urgent need to address the growth bottlenecks imposed by inadequate power supplies, traffic congestion in cities and major supply arteries for the export sector, as well as port facilities. A major challenge for Bangladesh lies in tapping domestic capital markets, for infrastructure projects which have large local construction cost components, thus channeling its high domestic savings of almost 30% into needed and profitable infrastructure investments.

A growing number of developing countries have developed their securities markets and long-term savings institutions, allowing them to tap domestic markets for infrastructure finance. India, Malaysia and a number of other countries in Asia have made some noteworthy progress in this area and we believe some lessons are relevant to Bangladesh.

If Bangladesh is to finance the tremendous infrastructure needs required to maintain GDP growth, it will also have to develop the institutions necessary to channel domestic savings into infrastructure investment as well as developing its bond markets as a means of providing long-term finance, especially important given the lengthy tenor of infrastructure projects.

Emerging market infrastructure programs have depended heavily on foreign financing sources, at least in their initial stages of development. Under-developed financial markets in many developing countries are unable to supply the volumes of long-term financing required by private infrastructure projects. According to the IFC, approximately 70 percent of the financing for its greenfield projects undertaken between 1966 and 1994 was derived from foreign sources. However, this heavy reliance on foreign funding has several drawbacks which can have particularly strong effects on infrastructure investments.

First, many infrastructure projects derive revenues denominated only or primarily in local currency. Where obligations to suppliers or providers of debt and equity are denominated in foreign currency, the project is exposed to *convertibility, transfer and exchange rate risks*. Since foreign investors are generally unwilling to bear these risks, risks are often shifted to the government or to consumers. For instance, project tariffs and debt are often indexed to and payable in foreign exchange by a purchasing state enterprise. This was the case, for example, in the power purchase agreement between National Power Corporation of the Philippines and the Subic Bay Corporation, which left the government with substantial exposure to exchange rate risk over the project's life. Second, negative movements in the exchange rate can lead to *asset-liability mismatch* leading to liquidity problems for project financing.

Exposure to such conditions can force governments to bail out projects that are deemed too important to fail, such as the toll roads in Mexico subsequent to the 1994 liquidity crisis.

Third, foreign ownership and financing of infrastructure may sometimes be politically unacceptable. Involving local investors through domestic financing for critical infrastructure can help reduce the political sensitivity of such projects. For these reasons, domestic capital markets can be an important alternative, or complement, to foreign infrastructure financing.

We see the potential for not only an infrastructure focused sovereign bond issue in the future, but also the opportunity for the Bangladesh Infrastructure Finance Fund, to issue sovereign backed bonds in the future. Moreover, the development of the corporate bond market would allow more companies involved in infrastructure, especially on a PPP basis, to issue longer-dated infrastructure bonds, which should also help alleviate the asset-liability mismatch from bank financing for infrastructure projects given the relatively short duration of bank assets.

1.2 Structural Problems in the Bangladesh Government Bond Market

1.2.1 Overreliance on Banks and National Savings

Probably the most significant structural problem in terms of the development of the Bangladesh Government Bond Market (BGBM), and one that is widely recognized by all the key stakeholders, including the GoB, is the lack of development of the institutional investor based and the over-reliance on banks to purchase BGBs. In 2013, around 85% of the stock of BGBs and Bills was held by the banking system. And the budget deficit was financed by 53% from Bonds and Bills, 34% from National Savings and 14% from overdrafts from Bangladesh Bank. In a study on the Primary Dealer system, Golden and Keating (see "Primary Dealers in Bangladesh: A Report for the Asian Development Bank", Chris Golden and Con Keating, March 2014) noted that:

"The National Savings proportion is unusually large by international comparison. Such a large proportion of national savings reduces the natural demand for Bangladesh government bonds. Furthermore it inhibits the development of other investment vehicles, such as mutual funds or assurance contracts, and suppresses the overall heterogeneity of the financial markets. Much of the banking system's holdings of government bonds have been imposed upon it on non-market terms under the process of devolvement. (35% of all bond and bill issuance between Jan 2010 and Jul 2013 was devolved upon unwilling takers)."

By way of comparison, National Savings constitutes 7.9%, 0.9% and 11.5% of government financing in the UK, US and India respectively.

In the Debt Management Performance Assessment (DeMPA) conducted by the World Bank in October 2013, on Question 3.3.1 “The extent to which market-based mechanisms are used to issue debt, the publication of a borrowing plan for T-bills and T-bonds, and the preparation of an annual plan for aggregate amount of local currency borrowing in the domestic market, divided between the wholesale and retail markets”, the Report gave Bangladesh a score of “D” noting that:

“because the GoB does not access the domestic market using market based instruments to meet 90 per cent of its projected borrowing needs (NSD borrowings are over 30 per cent and not at market rates). In addition there is 'devolvement' – a practice of forced subscription on PDs that is not in line with sound market practices.”

In a recent analysis (June 17, 2014) of the FY 2014/15 Budget, Dr. Ahsan Mansur, Executive Director, the Policy Research Institute (PRI) noted that:

“The government's fiscal deficit target of 5% of GDP is appropriate and should not give rise to any debt sustainability issue. However, the emerging pattern in the composition of financing with greater reliance on high cost domestic financing and relatively short maturity structure and associated very high degree of rollover is a matter that should get more attention in the financing strategy of the government. In particular, the government would need to diversify its sources of financing with proper mix of domestic and external financing, and on both fronts identify market based additional sources of financing.”

He went on to recommend that:

“On the domestic borrowing front, dependence on National Savings Schemes and short-term treasury bills should give way to long-term treasury bills and bonds, infrastructure bonds, etc. with proper secondary market and a well - developed yield curve for government bonds (which does not exist today). Bank financing primarily in the form of treasury bills of short maturities (one year or less) and nonbank financing of medium-term maturity (3-5 years) are not long enough in terms of maturity and the government must develop the market for long-term bonds with maturities of 10-40 years. This will help development of market-based yield curve and encourage longer maturity bond issues by the private corporate

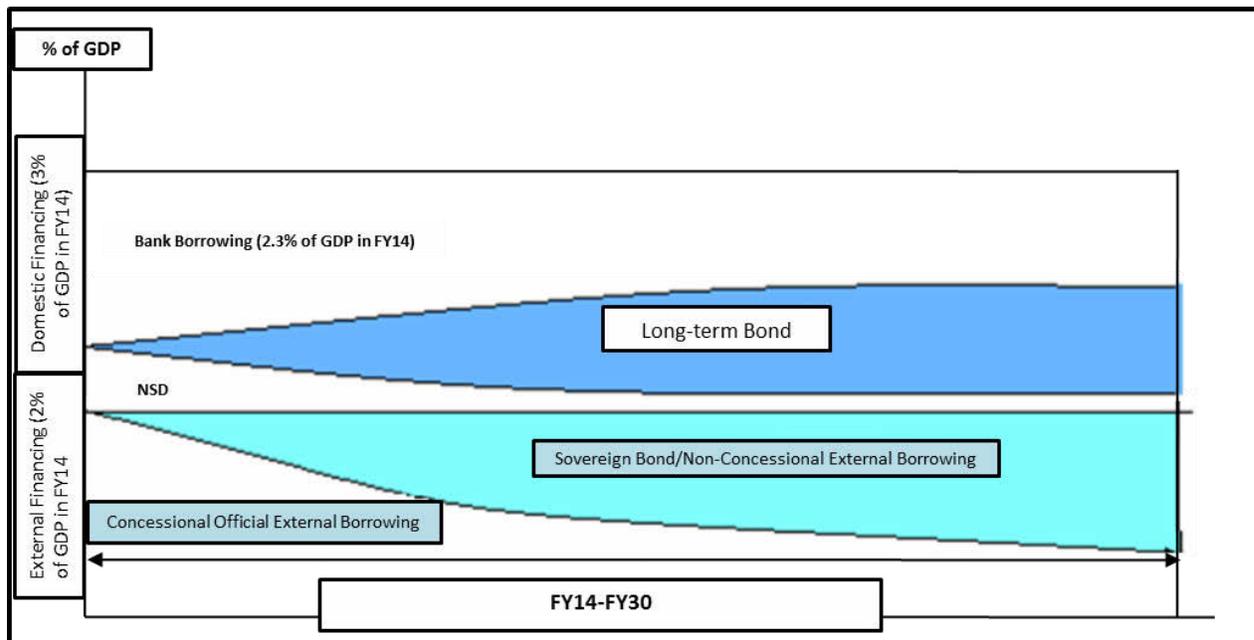
sector and public institutions for financing of investment projects and infrastructure."

He concluded by recommending that:

"The needed strategic transformations should be done on the basis of a comprehensive Government Financing and Debt Management Strategy to be prepared by the Debt Management Wing of the Ministry of Finance."

The figure below summarizes the long term forecasts for the transformation of government financing.

Figure 3 - Long-Term Restructuring of Financing of the Budget Deficit



Source: PRI Staff Estimates

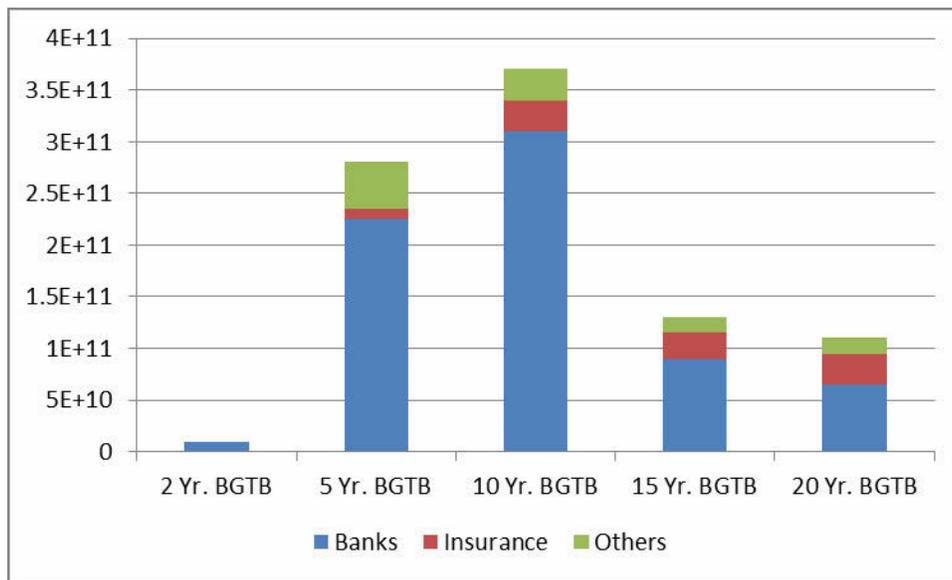
However, we would note that while we agree with the need to reduce reliance on National Savings and also increase external sovereign bond financing, the maturity mismatch for banks we highlight below underlines the need yet again to develop the bond market institutional investor base away from banks.

1.2.2 Mismatch in Maturity Profile

The average maturity of BGBs is exceptionally long at 7.3 years. This is nearly twice as long as the US Treasury Market. By contrast the average tenor of liabilities in the banking system, which is the current main deficit financing source, is only 1.3 years. This

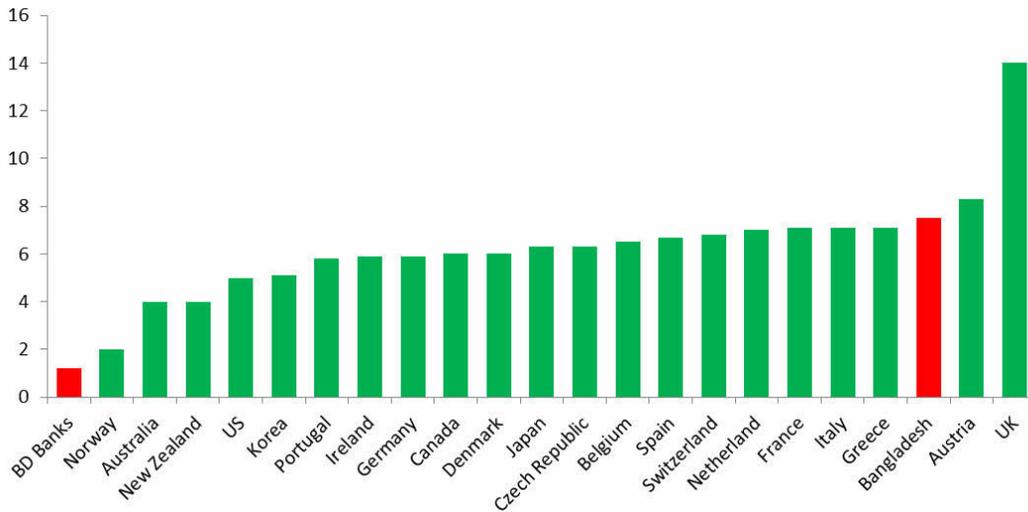
mismatch presents a major potential financial stability risk and is a major reason to accelerate the development of alternative institutional investors with longer liabilities such as insurance companies and pension funds.

Figure 4 - Maturity Profile of Bangladesh Treasury Bonds



Source: AT Capital Research

Figure 5 - Average Life of Government Bond Markets in Years (With Average Liability Tenor of Bangladesh Banking System)



Source: OECD, Bangladesh Bank

Table 1 – The Structure of Demand for Government Bonds-Banks

	91 Day Bill	182 Day Bill	364 Day Bill	2-yr Bond	5-yr Bond	10-yr Bond	15-yr Bond	20-yr Bond
Bank	90%	96%	88%	89%	82%	84%	82%	67%
Insurance	0%	0%	0%	0%	3%	9%	13%	25%
Other	10%	4%	12%	11%	15%	7%	6%	9%

1.2.3 Lack of Credible Yield Curve

There is strong evidence that many transactions in BGB secondary trading are not occurring at market prices and hence there is no credible government yield curve. This makes mark-to-market valuation of bonds difficult even on an implied or interpolated basis. The yield curve published by Bangladesh Bank is based upon the most recent issuance yields of government securities. Golden and Keating (2014) noted that:

“The curve currently published on the Bangladesh Bank website covers securities issued over a period of one month. This is not a yield curve as understood by financial analysts, for whom the yield curve is market price based and includes only recent observations. The central concept is that the curve is, in essence, tradable; that an investor or potential investor may execute transactions in the securities upon which the curve is based; and at prices close to those indicated in the yield curve. Such a curve must be based upon simultaneous and contemporaneous prices.”

They go on to highlight that the practice in most developed government bond markets is for yield curves to be based upon “benchmark” securities. These “benchmark” securities are the most actively traded issues in a particular maturity segment; usually this means that they are the most recently issued securities. It has become common (and best) practice to reopen issues of a given tenor over a long enough period for the accumulated outstanding stock to be of enough size as to give the issue the critical mass required by both investors and traders for it to be considered a “benchmark”. This is not what happens in Bangladesh. The current policy enacted by the Bangladesh Bank in the primary market is for almost every auction to create a new issue with a new ISIN. The final result of such a policy is to maximize the number of outstanding issues, and therefore to minimize the liquidity of any single one of them. To be clear: multiple issuances into a single general tenor maximize the fragmentation of market liquidity in that maturity spectrum. Golden and Keating (2014) concluded that:

“We are aware of that there is a move towards the occasional reopening of issues: we would strongly recommend that this be the rule rather than the exception; and that Bangladesh Bank preannounce the minimum size

required of accumulated auctions into the same tenor before it will consider the issuance of a new bond in the same maturity band. (i.e. any single ISIN bond would have a minimum size outstanding before a new ISIN is created in that maturity)."

1.2.4 Devolvement:

Devolvement in the BGBM occurs whenever an auction of government bonds is deemed not to have been covered at bids considered acceptable by the Auction Committee. In that case the bonds remaining to be issued after all acceptable bids have been accepted are "devolved" upon the entire PD group at a price determined by said committee. Since mid-august 2012 the catchment group includes all commercial banks. This policy has a number of consequences: devolvement of bonds creates a debt overhang that might more commonly be associated with a false market. In fact, there are often occasions when auctions receive enough bids to cover the announced issue volume, but devolvement still takes place. Under these circumstances it is obvious that demand for the maturity being auctioned did in fact exist, but not at a yield satisfactory to the issuing authorities. As a result the market fails to clear naturally, and the price broadcast to the market as a whole is obviously higher than the true free market rate. As such the market can truly be said to be false; and in addition if only by definition, the market has evidently been manipulated.

1.2.5 Absence of Short Selling:

It is almost impossible to conduct arbitrage between government bonds without the ability to short securities; and arbitrage is a critical element of an efficient liquid market. Accordingly, we concur with Golden and Keating (2014) in strongly recommending the abolition of the prohibition on short-selling at least for market makers in their ordinary course of business. With active arbitrage and market making, a further ancillary market can come into existence: the market for securities lending or reverse repo. In order to make delivery and settle short sales it is necessary for the market maker or arbitrageur to borrow these securities.

1.3 Bangladesh Government Bond Market Reform Strategy

The importance of developing government and corporate bond markets was a major focus in the Capital Markets Development Program II (CMDP II) published in 2012 (see page 117-148 of Final Report). A Bond Market Reform Roadmap needs to focus on a number of things simultaneously including:

- Reforms in the Primary Dealer System;
- A Review of BB debt management/issuance strategy;

- Reduced reliance on National Savings as a primary means of deficit financing and a review of optimal rates on those instruments;
- The development of a base of domestic institutional investors for government bonds, and reduced reliance on commercial banks as final holders of BGBs.
- Rationalization of transactions costs, including taxation, for secondary market trading of listed bonds.

1.4 Primary Dealer System and Debt Management

As outlined in Federal Reserve Bank of New York, "Administration of Relationships with Primary Dealers", January 10, 2010, (see: www.ny.frb.org and, Treasury Market Practices Group, "Best Practices", September 14, 2010, see: www.ny.frb.org/tmpg/best_practice_09142010.pdf) Primary dealers (PDs) are selected from among the larger, well capitalized commercial and investment banks that have competent trading desks, efficient back offices and a strong distribution network. A primary dealership is a prized business asset. The PD can buy on the bid and sell on the offer, earning a spread on a large inventory of government bills and bonds and this is normally a lucrative business. Because of the profitability of primary dealerships, there must be a set of well-defined rights and obligations on the part of primary dealers. Participation in this market is a privilege, not a right, and primary dealers assume certain responsibilities.

In well-developed government bond markets, primary dealers are expected to participate actively in the primary auctions with minimum success rates for acceptance of bids.

In secondary markets, they are expected to make two-way prices (bid and ask) and to widely distribute government debt among institutional and retail customers. Moreover, they are expected to provide the central bank with market intelligence on the state of the market and on their long and short positions which are then aggregated (guaranteeing anonymity) and published on the central bank's web page for the entire market to digest.

Bangladesh Bank established its primary dealer system in 2003 to assure the orderly underwriting of primary issues of Government debt and to catalyze the development of an active and well-functioning secondary market in Government securities in Bangladesh.

Primary dealers in Bangladesh enjoy the following benefits and have the following responsibilities:

Benefits:

- Access to primary auctions of government debt;

- An underwriting commission;
- A spread buying on the bid and selling on the ask;
- Receiving “special” liquidity support from the Bangladesh Bank to support their purchases of Government debt;
- Receiving priority over non-PDs in general dealings with the Bangladesh Bank.

Responsibilities:

- Participating in auctions and having a successful bid-to-acceptance ratio;
- Reporting price and volume information to Bangladesh Bank and to the Primary Dealers Bangladesh Limited (PDBL);
- Accepting “devolvement” (as per allotted quotas) of supplies of government securities not sold at auction.

As noted in the CMDP II Final Report, commercial banks have a Statutory Liquidity Requirement (SLR) of 19% of their demand and time deposits. They are required to hold 13% of their SLR as government securities. If there is insufficient demand for government securities by the financial system, the 15 primary dealers are expected to absorb the remaining amount – this is called “devolvement”.

In the last FY 11/12 to FY 12/13 period, increased pressure on the budget deficit due to rental power plants forced the primary dealers to purchase government securities in amounts far greater than required by their SLR.

However, the government would not have to “devolve” the excess supply of debt if market rates of interest would be paid on government securities - mainly because it is unlikely there would be such excess supply if market rates were paid. The definition of a “market rate” is one that is high enough to “clear” the market – i.e. one at which demand and supply are at equilibrium.

This situation results in primary dealers having to hold government securities acquired at auction in their portfolios until such time that there is a downward shift in the general level of interest rates that would enable them to sell them without having to take a loss, or alternatively, in the case of shorter term securities, keeping them until they pay off.

Yet, with such large discrepancies between the “market clearing” rate - i.e. that at which primary dealers would be able to “sell-on” (the secondary market) government securities acquired at auction (the primary market) - and the “cut off” rate, even such “buy-and-hold” strategies may be difficult to execute without incurring losses.

In this scenario, the size of the demand for government securities will necessarily be limited to the size of the balance sheets of “captive investors” - the principal determinant of their capacity to hold such investments.

Thus, we have seen that the size of fiscal deficits and the size of the debt auctions are exhausting and overwhelming the ability of the commercial banks and especially primary dealers to absorb public debt.

Signs that the primary dealers are straining under the obligation to buy government securities at below market rates of interest were reported, in the Final Report for CMDP II, as being “everywhere”. Some observations that report made:

- On 15 January 2012, a spokesperson for the Primary Dealers Bangladesh Limited (PDBL) told the media that their members’ business growth plans are being hampered by the substantial amount of government securities they must buy.
- Some primary dealers indicated their inclination to “surrender” their Primary Dealer License and discontinue participation in auctions while others informed us that they were not attending auctions – although still purchasing the amounts “devolved” on them.

The Final Report for CMDP II also noted that the main factors holding back the development of the government bond market were as follows:

- Issuing government securities at artificially-low rates;
- Market uncertainty about what rates should be beyond the very short-term;
- The absence of deep, liquid benchmark bonds in which secondary trading might develop;
- The reluctance of primary dealers to sell their bonds at a loss as they may be required to mark-to-market their entire portfolio;
- Insufficient mechanisms for trading transparency and price discovery.

It is self-evident that reform of the primary dealer system is an imperative and the CMDP II Final Report proposed the following policy actions:

- “Policy action: In the course of a future ADB technical assistance, Bangladesh Bank and the Bangladesh Primary Dealers Association should work to adopt a code of conduct as practiced in developed government bond markets as well as in India, Pakistan and Sri Lanka.” (p 125)

- Policy action: The government should focus on issuing more bonds at shorter tenors (2, 3, 5, and possibly 7 years), to develop the shorter end of the bond market. (P 126)
- Policy action: The government should adopt a policy of creating liquid benchmark issues through the use of reopening, switching, and buy-backs. (p 127)
- Policy action: The government should be more of a "price taker", and should seek to issue bills and bonds at market rates. (p 128)
- Policy action: The DMO should establish a medium term plan for managing the government debt portfolio. This should encompass restructuring the existing portfolio, and an issuance strategy going forward. (P 131)
- Policy action: The government should consider the secondment of an expert from overseas to assist in the ongoing implementation of the debt management plan. (P 131)"

As we mentioned earlier, these policy actions were indeed followed up by the appointment in 2013 of two leading International Bond Market Experts, Chris Golden and Con Keating, by the ADB (TA 7841 BAN), to review the Bangladesh Primary Dealer System and make a number of policy recommendations. They visited Dhaka for one week in 2013 and met the key regulators including Bangladesh Bank and MoF as well as a wider range of stakeholders including primary dealers, insurance companies and other market players. Some of their key findings included:

- Secondary Market Liquidity was *extremely thin*. There were a total of 772 transactions in the year examined - this is an extremely low number of transactions (surprisingly, 510 of these occurred at a price of 100)
- The authors were unable to price these transactions from other sources but do later examine the consistency of these few "market prices" with the published "yield curve". They found *consistent and substantial discrepancies* between them;
- There were a total of only 210 transactions serving an investment purpose, with an aggregate value of BDT 84,355 million. On a gross basis, this amounts to 3.1% of the stock in issuance and on a net basis 2.7% of the stock, over a period of one year. Comparable figures for other markets are several orders of magnitude higher. Of these 210 transactions, 62 took place at a price of 100.
- The data, covering more than two hundred trading days, revealed:
- Trades occurred on only 79 days - less than half those possible;
- 38 secondary trades took place on the issue date, or within one day of issue.
- Five banks account for 62% of secondary demand, while five others account for 73% of supply.

The study concludes that these low levels of turnover and demand indicate that it is neither **practical** nor **realistic** to expect primary dealers to be able to sell bonds which have been devolved upon them into the secondary markets.

In November 2013, the consultants made a presentation to key stakeholders with a number of policy recommendations. The policy roadmap was refined and recalibrated with a clearer set of priorities and timeline culminating in a very successful Bond Market Workshop held on May 19, 2014 at ADB Resident Mission Dhaka, at which Mr Chris Golden, presented the consultants' key recommendations. This saw attendance from senior officials from Bangladesh Bank as well as the Ministry of Finance and SEC as well as a number of other key stakeholders. The key recommendations are highlighted below, but it was noteworthy that BB and MoF seemed much more open and enthusiastic to considering some of the recommendations. This was evidenced by the decision by BB to hold a follow up seminar for the Bangladesh Primary Dealers Association, at BB, with Mr Chris Golden presenting. This step was extremely encouraging and gives grounds for optimism that material and substantial policy measures can be implemented if CMDP III continues to build on the renewed enthusiasm displayed by Bangladesh Bank and the Ministry of Finance to make genuine reforms to improve the efficiency and smooth functioning of the BGBM.

1.5 Primary Dealer Reform - Key Recommendations

In his presentation on May 19, 2014, Chris Golden made the following key policy recommendations:

- Revise the issuance procedure;
- Split the current issuance process into 3 maturity bands;
- Add FRNs to instruments issued;
- Apply different issuance methods to each band;
- Overhaul the PD system;
- Split PD system to correspond with maturity bands.

Mr. Golden also outlined a series of consultations between BB and the Primary Dealers including:

Consultation Session 1 – Issuance

- Money market maturities and Medium-term maturities to continue to be auctioned in the same way as they are now;

- Long maturities to be issued through an underwriting syndicate. This means that the syndicate will guarantee to purchase the entire issue (or reopening) at an agreed price. The (at least) two groups of PDs will compete to receive the mandate from BB, by each submitting the yield at which they are willing to underwrite the entire issue.

Consultation Session 2 – Making PD membership voluntary and attractive

- BB to ascertain from each existing PD whether that PD wishes to maintain that status, and if so in which maturity bucket(s) they intend to be a candidate;
- It would be stressed to each PD that they are free to drop out of the PD system with no stigma or consequences, and that if they do so they can always present themselves as candidate PD in the future with no prejudice;
- Any PD who indicated to BB at this time that they wish to drop out would be given a debriefing to ascertain why that PD no longer wishes to maintain their status and to discover what problems the PD encountered during their time as a PD and what solutions they would suggest to those problems;
- PDs who wished to remain as PD would be asked to provide a business plan to BB for each of the maturity buckets in which they are interested;
- Candidatures to specific maturity bucket(s) would remain confidential for the moment.

Policy Recommendations:

Short Term

- The number of PDs would be reduced to only 5 in any market segment;
- PD membership would be voluntary;
- PD membership would not be assumed to be permanent;
- PD performance would be monitored and evaluated on a regular basis;
- The prohibition against short selling would be removed for PDs in the ordinary course of business,

Medium Term

- The membership of the PD system would be re-evaluated every two years;
- The total number of PDs would not be assumed to be fixed, but may be increased if publicly justified;
- BB to investigate acceptance of global standards in the documentation and trading practices - ISDA templates were suggested;

- BB to monitor National Savings Certificate interest rate(s) to minimize competition with BGTB market.

Long Term

- BB to form a working group to study the practical requirements of creating a financial futures market;
- Develop Life Insurance and Pensions sector.

A key element for bond market development for CMDP III should consist of initiatives designed to help implement the above reform roadmap.

1.6 The Importance of Allowing Short Selling

Short-selling is the sale of a borrowed security . After a period of time, the short-seller will have to purchase the borrowed security back from the market, in order to deliver it back to the lender. Between selling and then buying back the security, the short-seller is said to have a short position. If the price of the security falls before it is bought back from the market, the *short position* will yield a profit (and vice versa). Short-sellers can borrow securities in the repo or securities lending markets.

The ability to engage in short-selling performs three important functions for the bond market:

- **Market-making** - Short-selling allows a primary dealer on an ongoing basis to quote prices for securities that he does not hold. If an investor buys one of these securities, the primary dealer can be sure of being able to deliver, because he knows he can borrow it, if he is unable to immediately buy that security. The resulting liquidity is a benefit for bond investors in enabling them to buy when they need a security, and not having to wait for a seller of that security to become available at that time. This in turn should reduce the cost of borrowing for issuers. A number of central banks or debt management agencies in more efficient bond markets offer special repo facilities to market-makers to allow them to borrow whenever the available supply in the market is inadequate.
- **Risk Management** - Short selling makes hedging possible, which in turn should improve risk management and reduce volatility in the bond market. A long position in a bond is hedged by a short position in a similar bond, so that, as prices fluctuate, changes in the value of one position will be substantially offset by opposite changes in the value of the other. Hedging allows the underwriting of new bond issues and is therefore essential to primary market liquidity.
- **Price Efficiency/Discovery** - If a bond is overvalued then the ability to go short will enable the market to move that security back to a fair value level. In this sense such an

activity should improve price efficiency and reduce the risk of market bubbles or prices moving too far away from their underlying fundamentals.

Of course there are risks in shorting securities which need to be managed prudently by the primary dealers as well as regulators. Firstly, when the price of the shorted security rises, the dealer who is short incurs a loss that increases proportionately with the rise in the price. There is an additional cost insofar as the dealer with a short position also needs to pay the ongoing coupon the actual owner of the bond would be earning if he had not shorted the bond. In this sense, dealers need to mark their positions to market and avoid incurring unsustainable risks.

In February 2012, Indian bond market regulators increased the period in which bonds can be sold short from 5 days to 3 months. However, the Indian rules are still overly restrictive. Dealers can only short securities they already own. According to regulation, these positions "need to be squared off by banks on a daily basis, by utilizing the RBI's repo window, where banks can borrow funds against deploying government securities".

We believe it's important that Bangladesh adopt a more pragmatic approach to short selling although it can be introduced in a staged manner. The key is to recognise that while risk management and prudent regulations are clearly important, overcautious short selling rules will limit the benefits in terms of improving market liquidity.

1.7 Developing the Foreign Investor Base

Increasing foreign investor participation in the BGB market will be an important element in reducing the pressure on banks and diversifying the investor base. In this context, BB has taken a number of encouraging initiatives including abolishing the lock-in period for Non-Resident Bangladeshi's (NRBs) as well as foreign investors more broadly in Apr 2013. In addition foreign investors are allowed to resell their BGBs to any investors in the market.

In another initiative, in April 2014, BB has relaxed regulations, allowing foreigners to invest in its treasury bonds by using Non-Resident Investor's Taka Account (NITA). Under the relaxations, the purchase is made with funds of a Non-Resident Foreign Currency Account (NFCA) or a NITA with a bank in Bangladesh in the name of the purchaser.

A senior BB official was quoted in the Financial Express, Apr 9, 2014 as saying: "We expect that it will help infuse dynamism into the country's secondary securities market through increasing investment in the BGTBs..."

So far it has been reported that foreign investors have purchased \$ 160mn of BGBs.

An important focus for bond markets development should also be to examine policy actions that can be taken to enhance further foreign interest in BGBs.

One suggestion made in a meeting with Dr. Atiur Rahman, Governor Bangladesh Bank, earlier this year, was to take specific feedback from some of the most active international fixed income managers who have already invested in the BGB as to reforms that would encourage them to increase their exposure to the Bangladesh market.

1.8 Developing the Local Investor Base

A first imperative for domestic capital market development is the accumulation of contractual savings pools, which channel savings towards securities, through institutional investors.

Contractual savings are defined as arrangements under which part of the income of individuals or groups is put aside and returned at a later stage in form of income, mostly at the time of retirement.

1.8.1 Measures to Help Stimulate Development of the Insurance Industry

Insurance companies are potentially among the most important investors in government bonds. While general insurance companies may invest to some extent in bonds as part of their liquidity management, the life sector is a “natural” buyer and should typically serve as a primary source of demand for long term fixed income securities. Life companies have long-term and statistically predictable liabilities. They therefore seek investments to match these liabilities. Government bonds, especially with medium and longer tenors, are typically an important part of their portfolio.

At present, the investment portfolios of insurance companies contain low levels of fixed income securities. This is reportedly due to two primary factors:

- Low secondary market liquidity, and
- Low levels of knowledge and sophistication of investment management staff in the insurance industry.

Insurance company demand for fixed income securities (including BGBs) should increase as liquidity improves. A key focus for bond market development should be on ways to encourage further insurance sector demand for BGBs both by reviewing (and possibly revising) the regulatory framework (with respect to investment policies) as well as an educational process for insurance companies. This could include such topics as:

- Best global practice in investment management for insurance companies.

- The benefits and drawbacks of investing in fixed income securities, and why they should be considered as a “staple” investment;

1.8.2 Measures to Help Stimulate Development of the Pensions Industry

Pension Funds and their annuities should provide strong demand for longer-term fixed income products. Holdings are generally very stable, with low volatility of overall portfolio sizes, and horizon holding periods tend to be long, in aggregate. Where markets are liquid, these investors, as is the case with life assurance companies, can be expected to play the role of arbitrageurs, smoothing out occasional aberrations in the yield curve, due to exogenously motivated transactions by other categories of investors, and their own long-term return horizons.

However, in Bangladesh, as reported elsewhere in this report, the state pension scheme is unfunded and private provident schemes are few in number and small in aggregate. Moreover, they tend to primarily invest in cash or cash equivalents in stark contrast to their counterparts in developed and even emerging markets.

An important focus for CMDP III should be how to encourage the development of a pension industry in Bangladesh that can provide demand diversification for BGBs away from the banking system. The initiatives required for this effort are reviewed in the section of this report devoted to pension and provident funds.

1.8.3 Catalyzing the Growth of Bond Mutual Funds

Mutual funds are also an area where institutional appetite in fixed income securities could be developed - in particular mutual funds dedicated to investing in fixed income instruments which could also provide an alternative liquid investment product to fixed bank deposits and national savings certificates.

There is currently only one bond mutual fund (outlined below) in Bangladesh. However, as of the last reported asset breakdown, 55% of its holdings were in cash or bank balances and there it actually held more (22%) in equities than in bonds (19%). Clearly more fixed income funds need to be launched but with clearer guidelines to be invested in bonds and not cash.

Table 2 – First Bangladesh Fixed Income Fund

First Bangladesh Fixed Income Fund	
Name	First Bangladesh Fixed Income Fund
Nature of the fund	Special Purpose Investment Fund with tenure of 10 years.
Objective	<p>The Fund will target 15-20% annual returns backed by the stability of fixed income stream from Fixed Income Instruments and boosted by selective investments in equity and hybrid instruments.</p> <p>The Fund's special objective includes development of the Bangladesh Bond Market by improving the demand side, promoting research based investing and becoming a captive buyer in the nascent fixed income market in Bangladesh.</p>
Listing Date	22-Feb-2012
Trading Date	March 19, 2012
Offer Price	Tk. 10.00 per unit
Face Value	Tk. 10.00 per unit
Market Lot	500 Units
Sponsor's Portion	200,000,000 units
Pre IPO Placement Portion	50,000,000 units
Public Offer	250,000,000 units
Size of the Fund in units	500,000,000
Size of the Fund in amount	Tk. 5,000,000,000.00
Asset Manager	RACE Management PCL
Sponsor	Eastern Bank Limited (EBL), ICB Unit Fund, Janata Bank Limited, Sonali Bank Limited

Table 3 – Breakdown of Assets as of June 30, 2013 (at cost)

Breakdown of Assets as of June 30, 2013 (at cost)		
	Amount	% of Total Assets
Listed Equities	1,254,279,609	22%
Corporate Bonds	15,279,275	0%
Non-Listed Bonds	1,085,499,753	19%
Cash & Bank Balances	3,170,959,134	55%
Preliminary and Issue Expenses	107,336,138	2%
Other Current Assets	124,071,672	2%
Total	5,757,425,581	100%
NAV per Unit at Cost	11.4	
NAV per Unit at Market	11.6	

The tax structure for mutual funds is also attractive and is laid out below:

- **No Tax on Capital Gain** - Mutual Funds are exempted from capital gain tax where Institutional investors have to pay capital gain tax of 10%.
- **Dividend Income is Tax Free** - There is no tax on dividend income for Mutual Funds, Institutional and Individual Investors have to pay 20% and 10% tax respectively on dividend income.
- **Tax exempted on Interest Income** - Interest income from Fixed Deposit Return (FDR) or other type of bank account is tax free for Mutual Funds where Institutional and Individual investors both have to pay tax of 10% on interest income.

Table 4 – Tax Structure for Mutual Funds

Investor	Capital Gain Tax	Tax on Dividend Income	Tax on Interest Income
Individuals	0%	10%	10%
Institutions	10%	20%	10%
Mutual Funds	0%	0%	0%

1.8.4 Tax Benefit of Mutual Fund Investors / Unit Holders:

- Dividend income of up to BDT 25,000 is exempt from income tax.
- Lower tax bracket for sponsor: Financial Institutions “– i.e. banks, merchant banks, insurance, leasing, portfolio management and stock broker-dealers - and any listed companies sponsoring” mutual funds pay 5% on any capital gains, whereas any other types of institutional “sponsors” pay the regular 10% capital gain tax.

To stimulate the growth of fixed income mutual funds, a measure that could be considered is to provide a higher tax exemption on interest income to unit holders of fixed income mutual funds. The amount would need to be the subject of study. The principle of “tax neutrality”, to which we adhere, suggests that it should be equal to the exemption enjoyed by unit holders in equity mutual funds (they are exempt from taxes on the first BDT 25,000 in dividends). Higher tax incentives may be considered provided that they are accompanied by a “sunset provision” making them self-expiring after some predetermined period – say five years – during which it might be reasonable to assume that that mutual fund sector would have grown to a critical mass.

1.8.5 Encouraging Greater Retail Distribution of BGBs

Given that it will take time to develop the Institutional Investor demand for BGBs, in addition to the suggested reforms of the Primary Dealer system, there should be a more focused effort to encourage retail demand for BGBs. This would also reduce the

reliance of National Savings Certificates. One suggestion to do this would be to broaden the distribution network and encourage brokerage firms and merchant banks to be allowed to sell BGBs and earn commissions for doing so in addition to the current reliance on primary dealers. There should also be a greater effort to educate retail investors on the scope for capital gains on BGBs in a falling interest rate environment in contrast to the lower returns they would experience if they only held National Savings Certificates or Fixed Rate Deposits with banks. Brokers as well as primary dealers can be supported by Bangladesh Bank in their efforts to offer such education programs on the attractions of investing in the bond market.

1.9 Conclusions – A Bond Reform Roadmap

The second primary dealer consultation was held on Sunday July 13 at Bangladesh Bank. At their request Ifty Islam made a presentation on bond markets development roadmap more broadly as well as on specific recommendations made by Chris in his presentation here in May. At BB request, the goal of the presentation was to ensure that all PDs were well informed and up to speed on conceptual issues and hence better able to give their feedback.

About 20 PDs attended so quite a good turnout. Sudhir Chandra Das, ED Debt Management, gave some opening comments followed by Mr. Bishnu Saha, GM debt management.

There was quite a lot of discussion and questions both during and after the seminar. We have received several follow up emails and calls. Among questions/comments raised were:

- The major concern from both BB and all the PDs was that without lack of significant progress on developing the demand side, much of the reform efforts on the PD system would not prove effective;
- In terms of major demand stimulus initiatives the majority of feedback emphasized the need to develop the pensions system with PDs wanting to know what initiatives were being taken within CMDP III or more broadly by GoB on this front;
- There was also some discussion on the need for effective enforcement of the 30% investment rule for bonds for insurance companies. BB expressed some frustration that IDRA has been slow in implementing that rule;
- There was some discussion on how to increase retail demand for government bonds. A major impediment appears to be liquidity to repurchase government bonds from retail investors and one PD suggested need for BB to develop a refinance window for government bonds for retail investors though BB was not positive on this;

- PDs also wanted greater focus on how to stimulate fixed income mutual funds in Bangladesh;
- There were a number of questions/concerns on how different PD groups would be selected for the proposed three maturity segments. Moreover there was a general consensus that demand for longer-dated issues would be weaker.
- Some PDs queried how syndicates would be formed and operated. They were encouraged by the suggestion that BB may need to pay a higher market yield on longer-dated issues to reflect the lack of end institutional investors in long segment and also fact PDs already overweight long dates bonds as a result of 2011/12 devolvement

The overall tone was more positive from both BB and PD which is expected to provide a base on which to build in the anticipated consultations.

There was further follow up by a presentation to the Primary dealers Association at Bangladesh Bank on August 28 By Mr. Chris Golden to the same audience. Likewise Messrs. Golden, Islam and Shoroka met with Mr. Nazmus Sakib Additional Secretary Debt Management, MoF, on two occasions August 24 and 28 to take feedback on the Bond Market Reform Roadmap. In subsequent meetings on September 1 with Mr. Iffy Islam, both MoF and Bangladesh Bank have maintained their enthusiasm to see reforms progress and there has been some provisional agreement to actively consider the introduction of Floating Rate Notes (FRNs) as a new instrument in Bangladesh Bank's issuance strategy. We believe if we maintain continued dialogue with both BB and MoF as well as key private sector stakeholders then further reforms in the primary dealer system such as specialization across three maturity segments and syndications in the long end are also achievable.

In follow up discussions with Mr. Islam, BB requested a technical guide book on the operational issues surrounding FRNs as well as providing guidance as to the practical challenges of introducing FRNs into the BGB market. There was also a request for a workshop on FRNs and syndications both for BB and MoF officials as well as the Primary Dealers. Mr. Chris Golden produced the requested technical guidebook on FRNs and this was given to both BB and MoF in December 2014. A guidebook on bond syndications was also produced.

Below we summarize some of the key features of an effective bond market reform roadmap with a series of policy actions.

Policy Action 1 – Issuance to deepen benchmarks

It is encouraging that Bangladesh Bank has recognized the importance of improving the liquidity in key benchmarks as a key factor in establishing an effective and

meaningful government benchmark. It is noteworthy that BB has been reissuing 10 year bonds since 2013 and 15 and 20-year bonds since 2014,. In that case a particular amount of bond is issued having the same ISIN. We recommend that Bangladesh Bank continue this process and step up their targeting of new issues into these benchmarks to improve liquidity in the market further. We also recommend that the infrastructure be put in place to support the existence of a “When Issued” market. As a minimum this infrastructure amounts only to the ability to trade for a future settlement date. There is merit in terms of establishing a “When Issued” market at some point in the future given the informational value of such trading. When such a practice has been introduced then a summary report of new issue trading activity could be compiled and each sale of new stock by auction or syndication should include the existence of a when- issued market for at least one week prior to the sale. However, we also recognize that it is important not to introduce “When Issued” trading or indeed “short selling” prematurely and the market regulators need to balance the need to avoid de-stabilising the market by bringing in new market innovations too early.

Policy Action 2 – Issuing Floating Rate Notes

We also recommend adding a new instrument, Floating Rate Notes, to the BGBM. These can be defined as are bonds that pay a variable coupon related to a money market reference rate, such as LIBOR plus a fixed spread, usually quarterly.

Some advantages of issuing Floating Rate Notes (FRNs) include:

- Low price volatility which should encourage secondary market trading. This is particularly important given the recent experience of Bangladeshi PDs suffering large losses due to devolvement.
- Based on money market rates reflecting the cost of funding and hence would be more attractive for bank PDs.

Policy Action 3 – Syndicating Long Dated Issues

We agree with the recommendation of Golden and Keating (2014) that BB would seek to establish at least two groups of banks and or securities houses which would compete to underwrite BGTBs in 15- and 20-year maturities. Each group would tender the terms and conditions (essentially price and coupon, but also whether this would be a re-opening of an existing BGTB) under which they would be willing to guarantee the delivery of full proceeds to BB on the completion of an offer, subject of course to an underwriting fee. This method of issuance would preclude the need for devolvement since the winning syndicate would be bidding for (i.e. underwriting the sale of) the whole auction at the winning price/yield.

Policy Action 4- Reforms to the PD System

The number of PDs would optimally be reduced to 15, be voluntary in nature, and split into three groups of 5 PDs , each of which would focus on the 0-1 year (money markets) segment, 2 and 5 year medium sector and 10,15 and 20 years or long maturities. This will be established in the aftermath of the consultation phase of meetings between BB and PDs we outlined earlier.

Policy Action 5 – Allowing Short Selling

There is a suspicion among some regulators that short selling is all about speculation or is inherently wrong. However we believe it is a critical part of hedging for primary dealers and should be allowed in the course of their normal business. As Golden and Keating (2014) noted, the ability to borrow bonds directly or indirectly from clients or their custodians via a Stock Lending (SL) agreement and the ability to source the bonds via Reverse Sale and Repurchase Agreements (Reverse Repos) in order to deliver bonds that they do not hold when they have sold them to clients in their ordinary activities of market-making. SL and Repos are thus the primary sources of bonds for traders who sell bonds that they do not currently have in position on their trading books in order to honor their commitment to make two- way prices in government bonds. Indeed one or both of these, together with a government bond lender of last resort, is essential to achieve optimal liquidity in a GBM.

We believe it is important that Bangladesh adopt a more pragmatic approach to short selling although it can be introduced in a staged manner. The key is to recognise that while risk management and prudent regulations are clearly important, overcautious short selling rules will limit the benefits in terms of improving market liquidity. Hence we believe BB should introduce short selling for 30 days and not be limited to just shorting securities that they own. BB would need to monitor the evolution and development of short selling and dealers would should provide the regulator with daily information on

short positions to re-assure on prudent risk management, But we believe the introduction of short selling will not only improve liquidity but also provide the market infrastructure necessary for the introduction of bond futures and other derivatives in the future.

Policy Action 6- Fiscal Incentives to Catalyze the growth of Bond Mutual Funds

BB works with MoF to review the tax treatment of coupon payments received via investment in fixed income mutual funds to increase their attractiveness. We recommend increasing the tax free allowance to BDT 25,000 at a minimum which is the same level of tax relief presently allowed for investors in Equity Mutual Funds. However given that there is only one fixed income mutual fund versus more than 60 equity mutual funds, there may be a case for more generous fiscal incentives for bond mutual funds. Greater tax relief should be accompanied by sunset provisions.

Fiscal incentives have been adopted in India to encourage the growth of Infrastructure Debt Mutual Funds. The withholding rate on interest to be received by non-residents was reduced to 5%. The Finance Act, 2013, also reduced the dividend distribution tax rates for income distributed by an IDF MF to a non-resident from 12.5% / 30% to 5%. The amendment is expected to support the growth of Infrastructure MFs.

Bangladesh's bond mutual fund sector, with only one fund outstanding, may merit a similar approach in terms of introducing fiscal incentives as that taken in Indian for Infrastructure MFs.

Policy Action 7 – Establishing a funded public pension system and stimulating private pensions industry

Pension funds are perhaps the most natural buyer for BGBs and the absence of a developed pension scheme is perhaps one the most significant missing links in improving liquidity. We have heard that Bangladesh Bank is already taking the initiative and is about to publish regulations that require all commercial banks to have provident schemes/pensions. We believe MoF can extend this to the broader corporate sector. The pressure post Rana Plaza to increase worker benefits in the RMG sector again throws open the prospect for the 4 million workers in that sector to have compulsory pension schemes. A subset of the existing asset management industry could also specialize in pension fund management and provision as is the case in regional best practice. In addition, Bangladesh can take lessons from the successful transition towards a funded state pension system in India.

In conclusion, the BGBM is not functioning effectively and operating as it should to minimize funding costs for the MoF and GoB. This is due to range of factors from the lack of institutional investor base, excessively high National Savings Rates and an issuance

policy that has penalized Primary Dealers. Ultimately, issuing bonds via devolvement to PDs that don't want to buy them at interest rates that impose an immediate loss is ultimately unsustainable. A well-functioning market needs profitable market intermediaries who make markets and provide liquidity because it is commercially attractive to do so. However, we are encouraged by the open-mindedness of BB and MoF to reforms to improve the effective functioning of the BGBM and remain optimistic that meaningful improvements can be seen if all the stakeholders collaborate in the reform roadmap we have outlined above.

Corporate Bond Markets

1.10 The Importance of a Corporate Bond Market

Corporate bond markets really first took off in the 19th century in the financing of railroads in the US, UK and Europe with well collateralized and defined assets, namely the railroads themselves, making it relatively straightforward to issue financial paper to finance those projects. However, corporate markets in developing countries have more recently taken time to develop and, with the exception of a few Asian countries, corporate bond markets traditionally have been underdeveloped in most emerging markets. This usually reflects the dominance of bank lending—and the close relationship between corporates and banks.

However, the development of corporate bond markets can avoid concentrating intermediation on banks. It is better to spread some corporate risk in capital markets than to concentrate *all* corporate risk in the banking system. Such concentration of risk no doubt accentuated the 1997–98 Asian financial crisis. There is also a governance issue that can be very important in countries where banks dominate financing/lending decisions. It has also been argued that one way to limit the growth of nonperforming assets is to slow the growth of bank deposits by encouraging households to shift their savings into capital market instruments.

In the light of recent banking irregularities such as the non-performing loans to Bismillah group as well as the Sonali Bank scandal, regulators have been focusing to a greater extent on reducing banks counterparty risk. More specifically, encouraging corporates to find new sources of financing outside their traditional reliance on banks has been a theme that has emerged in BB's Monetary Policy Statements. They have emphasized the need for companies to find non-bank sources of finance such as IPOs, corporate bonds and private equity.

Corporate bond issues will also allow companies in principal to access a much wider pool of funds from both an expanding domestic institutional investor base as well as foreign fund managers in a way that would not be possible if they purely relied on bank financing.

1.11 Requirements for a Corporate Bond Market

Many factors are important for the development of a corporate bond market, including:

- A well-functioning government bond market, providing a risk-free yield curve;
- An efficient issuing process, whereby issuers can access the market in a timely and economical fashion;
- The ability to assess credit risk, requiring reliable financial information from issuers and credible ratings;
- Clearly defined and effective remedies for bond-holders in the event of default.

CMDP II highlighted a number of constraints on the development of the corporate bond market in Bangladesh along with several policy recommendations.

Table 5 – Listed Corporate Bonds and Dollar Denominated Bond

Name of the Bond	Issuer Company	Issue Size (in BDT mn)	Issue Date	Tenor	Rate
Listed Corporate Bonds:					
ACI 20% Convertible Zero Coupon Bonds	ACI	1,336	30-Dec-09	5 years	9.5%
Brac Bank 2% Subordinated Convertible Bonds	Brac Bank	3,000	12-Oct-10	7 years	182 day T bill reference rate + 6.5% margin with 12.5% floor; 2% margin in case of creditworthiness downgrade or breach of covenants
IBBL Mudaraba Perpetual Bond	Islami Bank	3,000	15-Jul-07	n/a	12.8%
Dollar Denominated Bond:					
Banglalink	Banglalink	USD 300	28-Apr-14	5 years	8.9%

Table 6 – Non-Listed Bond

Non-listed Bond:	Structure	Amount (in BDT mn)
United Commercial Bank	Floating Coupon Rate	2,000
Dhaka Bank	Fixed Coupon Rate	2,500
National Bank	Fixed Coupon Rate	2,500
One Bank	Floating Coupon Rate	2,200
IDLC Finance	Zero Coupon Bond	1,500
Bank Asia	Fixed Coupon Rate	700
Banglalion Communications	Convertible zero coupon	2,800
Grameenphone	Fixed Coupon Rate	4,250
Orascom Telecom (BD) Limited	Fixed Coupon Rate	1,000
Renata	Fixed Coupon Rate	1,000
Prime Bank	Floating Coupon Rate	2,500
BSRM	Convertible Fixed Coupon Rate	2,000
First Security Islami Bank	Floating Coupon Rate	2,500

Some of the key constraints cited in CMDP II included:

- Government bonds and the National Savings Scheme are tax advantaged and this preferential tax treatment is not available for corporate bond investments. Moreover, there is a levy of transfer fees on property transfers outside of a trust that has discouraged secondary trading. As a result, corporate bond issues are done inside the legal mechanism of the trust which is free of property transfer fees.
- The poor quality of corporate accounting and financial disclosure has not been conducive to the building of investor confidence. The maintenance of two sets of corporate books – one for the tax authorities and the second the firm's true financial condition – leave the bond issue manager in the unenviable position of explaining to investors that the corporation's financial health is really better than indicated in its public disclosure. The root causes of this go back to weak enforcement, by the private accounting and auditing associations, of international accounting standards.
- The regulatory approval process for corporate bond issues has traditionally been lengthy – on the order of six to eight months – and was a complicated, multi-step process. Market participants had observed that the SEC had not yet issued regulatory rules for corporate bond issues that clearly spelled out the procedures involved. Moreover, market participants had reported that the market interest rate frequently moved away from the bonds' initial offer price and that it was often not possible to place the issue after such a lengthy review process.

Some of the policy actions recommended under CMDP II were:

- The SEC should issue clear and precise corporate bond issuance procedures. This streamlined approval process should introduce a faster, lower cost private issuance process aimed at institutional investors (Eligible Institutional Investors - EII). The corporate bond issues directed at EII-only investors would have reduced information requirements and lower cost procedures.
- Facilitate private bond issuance by introducing a regime for private placements, with criteria for eligible investors, restrictions on tenor and terms, and minimum denominations. Such issues would receive SEC approval within 10 working days.
- Corporate bond issues suffer from a lack of liquidity and secondary market activity for all the reasons that are generally problematic for the government and corporate bond market in Bangladesh, namely a lack of institutional investor base for bonds and high levels of government savings certificate rates making bond yields less attractive. Another policy action would be to reduce the cost of funding and/or increase the post-tax yield via fiscal action. The suggestions were:
 - BB may consider including bank issued bonds as eligible for banks' SLR (statutory liquidity requirement);
 - BB may consider making bank issued corporate bonds eligible for repo transactions. At the present time only BGBs are eligible.

1.12 Improvements in the Regulatory Framework for Issuing Corporate Bonds

The process of obtaining approval from the Bangladesh Securities and Exchange Commission for issue of debt capital by locally incorporated companies has been further developed and provided its own approval track upon the approval of the **Debt Private Placement Rules on October 14, 2012 (Appendix 2A)**. Before this change in the regulations, all bond issues of debt, whether public or private, had to be issued under the following rules:

Convertible and Non-convertible Debt Issue for Public Subscription/Listing: Public Issue Rules, 2006 (Appendix 2B) is the Public Issue Rules 2006, which is the basis for any public offering, including those of non-convert debt securities (BRAC Bank Bond, Islamic Bank Bond, etc.). It suffers from a lengthy process, similar to an IPO, with a full prospectus, onerous documentation and compliance requirements, etc., as would be required for an Initial Public Offering (which is defined to be an offering of securities to more than 400 legal persons and expected to be listed in a stock exchange in Bangladesh).

There is no meaningful scope for EIIs to participate in IPOs of debt locally, as the market lots for investors, other than mutual funds and NRBs, are composed of 100 - 400 units of Tk. 10 per instrument, which are allotted as per lottery of one market lot per investor. In case of under-subscription, the mutual fund oversubscription takes over, and following

further under-subscription, the underwriters take up the issue up to 50%. If it is still under-subscribed, the issue is then cancelled.

There is no restriction on foreign investors participating in the acquisition of listed debt in Bangladesh, and the interest payment should be freely repatriated as a benefit of a listed security investment.

1.12.1 Non-Convert Debt Issue for Private Placement: Debt Private Placement Rules (Appendix 2A)

This is a new rule enacted on Oct 21, 2012, which replaces the need for local companies to issue debt by complying with the overall capital raising rules. The key requirements are the need for a trustee, which has been codified, along with the consent being valid for 1 year. The IM and application details, along with obligations of the issuer, sponsor, trustee, etc. are detailed.

Both tangible and intangible assets are included in BSEC measurements - i.e. an average value is taken for the purpose of pricing of equity being offered for subscription. Otherwise, intangible and tangible assets are both included in the valuation parameter for debt issue rules parameter.

This would be valid for issue of debt by a local company, whether the debt was placed to local or international buyers, as the nationality of the buyer, whose limit is restricted to 100, is not stated anywhere. In case of private placement of debt in a foreign currency, the BB and BOI approval shall be triggered.

Some specific comments on the Debt Private Placement Rules follow:

'**Debt equity ratio**' requirements while discussing preference for 'moderate' leverage appropriate for the sector, it does includes a 60:40 debt equity ratio ceiling.

Extract: 3 (3), Conditions to be fulfilled prior to make an application for issuance of debt securities. – An issuer may make an application to the Commission for issuance of debt securities, subject to fulfillment of the following:

- Total debt of the issuer, including the proposed issue, does not exceed 60% (sixty percent) of its total tangible assets;
- Provided that in case the debt-equity or capital adequacy ratio of an issuer is determined by its primary regulator, the issuer fulfills that requirement;
- Provided further that the Commission may consider variation of the above-mentioned ratio, if it thinks fit taking into account the industry scenario of the issuer.

Comment: Both tangible and intangible assets are included in BSEC measurements, as the information regarding Net Worth does not specify whether it is tangible only. (Schedule A No. 10, Schedule B 14 (q)). Providing a debt/equity ceiling of 60/40 does not have any basis, giving no regard to optimal amounts for different sectors and also different borrowers re credit risk. This gives rise to the risk of 'good quality' companies/projects capable of higher levels of leverage being restricted.

'Shareholder Approval' requirements while issuing bonds or notes for continuous financing for efficient management of debt in a dynamic environment may be considered a challenge.

Extract: 3 (9), The issue has been approved by the Board of Directors or governing body of the issuer and in case the issuer is a listed company, by the shareholders in a general meeting.

Extract: 4 (3h) [The Company to submit the] minutes of the general meeting approving the issue, in case the issuer is a listed company

Comment: Bonds issued by well run and managed corporates, both domestic and MNCs, should become a regular matter of business financing options, similar to large syndicated loans. As a result, the requirement for shareholder approval, especially for well-capitalized listed companies, prohibitively raises the cost of doing business.

'Finalized Term Sheet for Application' requirement is a challenge where the bond is to be placed internationally, where the concept of the road show, pricing and final subscription and allotment takes place consecutively over a period of a few weeks / months.

Schedule A (Summary of the Application), requires the following:

- a) Total amount of debt due from the issuer:
- b) Type of collateral securities being offered:
- c) Type of debt instruments to be issued:
- d) Face value, issue price and number of securities being offered and the total issue amount:
- e) Coupon rate/discount rate and YTM:

Information Memorandum, 2 (1) 6: Features of the debt securities to be issued, namely:

- a) Basic Features of the instrument;
- b) Rate of return, Yield to Maturity, Coupon/Discount Rate;

- c) Transferability/Liquidity;
- d) Prepayment, Call, Refunding, conversion features;
- e) Late Redemption;
- f) Tax Features;
- g) Costs related to the issue;
- h) Repayment Schedule;
- i) Enforcement of charges over securities.

Comment: The final instrument issued may be materially different from the initially conceived application due to the dynamic international market or wish to issue securities domestically where the pricing would have to be determined through a discovery process. In that case, the issuer would have to revert with a new application to the BSEC, obtain the approval over the next few weeks, and revert back to the interested investors, during which time the market could conceivably change again. As such, the cycle would put the issuer of large internationally placed debt in a cycle of non-success.

1.12.2 Rules Governing the Private Issuance of Convertible Debt

Private Convertible Debt, in case of equity conversion triggering any issue of equity which takes the total equity of the issuer to excess of BDT 100 million : REQUIREMENTS AS UNDER ISSUE OF CAPITAL RULES, 2001 FOR PRIVATE LIMITED COMPANIES FOR RAISING CAPITAL EXCEEDING TK 10,00 CRORE (Appendix 2C, first part)

For convertible debt issues for private placement, the rule applicable is the capital raising rules, which is meant mainly for equity. However, the conversion raising the capital past BDT 100 million will trigger compliance with these rules. The consent takes about 3 – 4 months, with much scrutiny on the company issuing the security.

In case of private placement of convertible debt in a foreign currency, the BB and BOI approval shall be triggered.

1.12.3 Rules Governing the Issuance of Preference Shares: Above equity related rules

Legally, preference shares, even though financially a debt obligation, is considered an offering of equity by BSEC, and as such, shall trigger BSEC approval for capital raising or IPO, depending on the market for the security being offered.

As the preference share payment is considered a dividend, and is subordinated to the debt coupon payment, and may not take place if the company does not perform, the BB and BOI rules may not be applicable.

At the same time, an international preference share offering can be in BDT, in which case, the BOI / BB will not be brought into the picture for approval.

In case of private placement of preference shares in a foreign currency, the BB and BOI approval shall be triggered.

1.13 Policy Actions for Corporate Bond Issuance

'Debt equity ratio' requirements while discussing preference for 'moderate' leverage appropriate for the sector, it does includes a 60:40 debt equity ratio ceiling.

Comment: Both tangible and intangible assets are included in BSEC measurements, as the information regarding Net Worth does not specify whether it is tangible only. (Schedule A No. 10, Schedule B 14 (q)). Providing a debt/equity ceiling of 60/40 does not have any basis, giving no regard to optimal amounts for different sectors and also different borrowers re credit risk. This gives rise to the risk of 'good quality' companies/projects capable of higher levels of leverage being restricted.

Policy action: Suggest removing the specific '60/40' ratio

'Shareholder Approval' requirements while issuing bonds or notes for continuous financing for efficient management of debt in a dynamic environment may be considered a challenge.

Comment: Bonds issues well run and managed corporate, both domestic and MNCs, should become a regulator matter of business financing options, similar to large syndicated loans. As a result, the requirement for shareholder approval, especially for large capitalized listed companies, prohibitively raises the cost of doing business.

Policy actions:

- It would be recommended that corporates seeking to tap the domestic debt placement market be allowed to take broad approvals at their AGMs for issuance of bonds for the next calendar year;
- At the same time, the shareholders at the AGM may amend the Memorandum of Association (MOA) and Articles of Association (AOA) to empower the Board of Directors to issue domestic debt as and when required. These AGM approvals may be considered by the BSEC in lieu of specific bond approvals to encourage companies to issue the instrument in the local market.

'Finalized Term Sheet for Application' requirement is a challenge where the bond is to be placed internationally, where the concept of the road show, pricing and final

subscription and allotment takes place consecutively over a period of a few weeks / months.

Comment: The final instrument issued may be materially different from the initially conceived application due to the dynamic international market or wish to issue securities domestically where the pricing would have to be determined through a discovery process. In that case, the issuer would have to revert with a new application to the BSEC, obtain the approval over the next few weeks, and revert back to the interested investors, during which time the market could conceivably change again. As such, the cycle would put the issuer of large internationally placed debt in a cycle of non-success.

Policy Action: It would be recommended that corporates seeking to embark on a process of price discovery be allowed to obtain BSEC approval through a range of term sheet variables.

Issuance of Foreign Currency Denominated Debt

There are presently no as per BSEC guidelines, as the issuance of debt denominated in foreign currency is treated as the jurisdiction of the BOI and BB. Interestingly, BSEC rules do not state anywhere what would be the provisions/waivers if all of the debt was placed overseas. The issue is not address the issue at all, implying that the approval will be required locally but the investors may not need to be domiciled in Bangladesh.

In case of any change in the features of the instruments, in the case of a private placement, even in a foreign currency (triggering BB and BOI approvals), it is likely that any change can be averted by obtaining a quick second approval due to any change in the listed security terms.

The second approval would not have to follow the full approval process, but a letter to BSEC asking for an approval due to a change. If the BB approval is there, BSEC will usually comply with its approval, in case of foreign debt.

In the case of a public issue of debt, in a foreign currency, where there is a change in the instrument's features and due to the final pricing, the rules are vague, as any change in the approved prospectus for public issue is a matter of notification as per compliance of the Public Issue Rules, 2006.

In the case of a public issue of debt in a foreign currency, using the book building method, finalization of the terms of the instrument in the foreign currency portion, whether in part or full, may also trigger a change in the pricing of the local currency portion, if any. A notification or a revised prospectus may have to be issued in such cases.

1.14 A New Regulatory Framework for Foreign Currency Corporate Bond Issuance

The development of a foreign currency financing regulatory framework is an important element in Bangladesh corporate financing in giving companies an additional avenue for financing and reducing their reliance on bank borrowing. It's clear that the move needs to be prudently managed with respect to individual corporate foreign exchange and credit risk as well as the aggregate level of private sector foreign currency indebtedness relative to the domestic banking system.

Banglalink, the second largest telecoms company in Bangladesh, sold \$ 300mn of a 5 year bond, at a coupon of 8.875%. It was reported that in terms of geographic distribution, 64% of the bonds were sold in Asia, 29% in Europe and 7% in the US. By investor type, asset managers accounted for 72%, private banks 17% and banks 11%.

The issue was noteworthy on two fronts. Firstly it was done in the absence of of the Government of Bangladesh launching its own foreign currency sovereign bond. Secondly it was made without any formal dedicated approval mechanism for foreign currency bonds.

We believe that the Bangladesh regulators should adopt an automatic approval mechanism for foreign currency bond issues in a similar manner to the Indian regulatory framework which has operated quite effectively. This would streamline the approval process and reduce bureaucratic delay.

1.14.1 Lessons from Indian ECB Borrowing Rules

India has seen a dramatic rise in private sector foreign currency borrowing over the past two decades but this has been accompanied by a sizeable increase in FX reserves as well. The regulatory framework and the evolution of the rules are perhaps the most relevant benchmark for Bangladesh.

In India, foreign currency borrowings may be in the form of External Commercial Borrowings (ECBs) under a loan agreement, senior unsubordinated or subordinated unsecured notes or bonds, foreign currency convertible bond or foreign currency exchangeable bonds.

ECBs can be bank loans, buyers' credit, suppliers' credit, securitized instruments, floating rate notes, fixed rate bonds, non-convertible, optionally convertible or partially convertible preference shares and debentures from non-resident recognized lenders with minimum average maturity of 3 years.

Except for compulsorily convertible preference shares and debentures (which are treated like equity including for FDI), all other kinds of preference shares and

debentures are classified as 'debt' for the purpose of foreign investment and therefore, are subject to the ECB guidelines. They are subject to conditions relating to, inter alia, borrower and lender eligibility, rate of return, maturity period, all-in-cost ceilings and end-use of proceeds.

The automatic route and approval route for raising ECBs

ECBs can be accessed under two routes: (i) automatic route; and (ii) approval route. The automatic route does not require the borrower to obtain any Reserve Bank or Gol approvals, whereas the approval route refers to circumstances where prior Reserve Bank and/or governmental approval is mandatory before raising ECBs. In the event of any doubt regarding ability to use automatic route, an ECB applicant may take recourse to the approval route.

Which are the entities which can raise ECBs under the automatic route?

Companies in industrial sectors, infrastructure sector in India and specified service sectors (i.e. hotel, hospital and software sectors); (ii) infrastructure finance companies (except financial intermediaries such as banks, FIs, HFCs and NBFCs); (iii) units in SEZs; (iii) MFIs registered under the Societies Registration Act, 1860, Indian Trust Act, 1882 or national/state level cooperative Acts; (iv) NBFCs categorized as NBFC-MFIs; (v) companies registered under Section 25 of the Companies Act and (iv) NGOs engaged in micro finance activities, subject to fulfillment of certain additional conditions. Individuals, trusts, and non-profit making organizations are not eligible to raise ECBs.

Who can provide ECBs under the automatic route i.e. who are the recognized lenders?

ECBs under this route can be raised from internationally "recognized lenders" such as: (i) international banks; (ii) international capital markets; (iii) multilateral FIs, regional FIs and government owned development FIs; (iv) export credit agencies; (v) suppliers of equipment; (vi) foreign collaborators; or (vii) foreign equity holders (for ECB up to US\$5 million, it must directly hold at least 25% of the paid-up equity of the borrower company and for ECB more than US\$5 million in addition to the shareholding requirement, the ECB liability-equity ratio must not exceed 4:1). The borrower must always obtain a loan registration number from the Reserve Bank before drawing down the ECB (generally obtained by submission through the AD).

What are the maturity and pricing restrictions (if any) for an ECB?

Under the automatic route the minimum average maturity level of ECBs must be as follows:

Amount	Minimum Average Maturity	All in cost over 6 month LIBOR
ECB up to US\$20 million	Not less than 3 years	350 basis points
ECB between US\$20 and US\$ 3 billion	Not less than 5 years	500 basis points

The all-in-cost payable in foreign currency includes the rate of interest and all other fees and expenses (excluding commitment fees, prepayment fees, withholding taxes and fees payable in Indian Rupees). If the lending entity does not meet the conditions under the automatic route a foreign lender (or borrower) may deviate from such conditions with prior Reserve Bank approval.

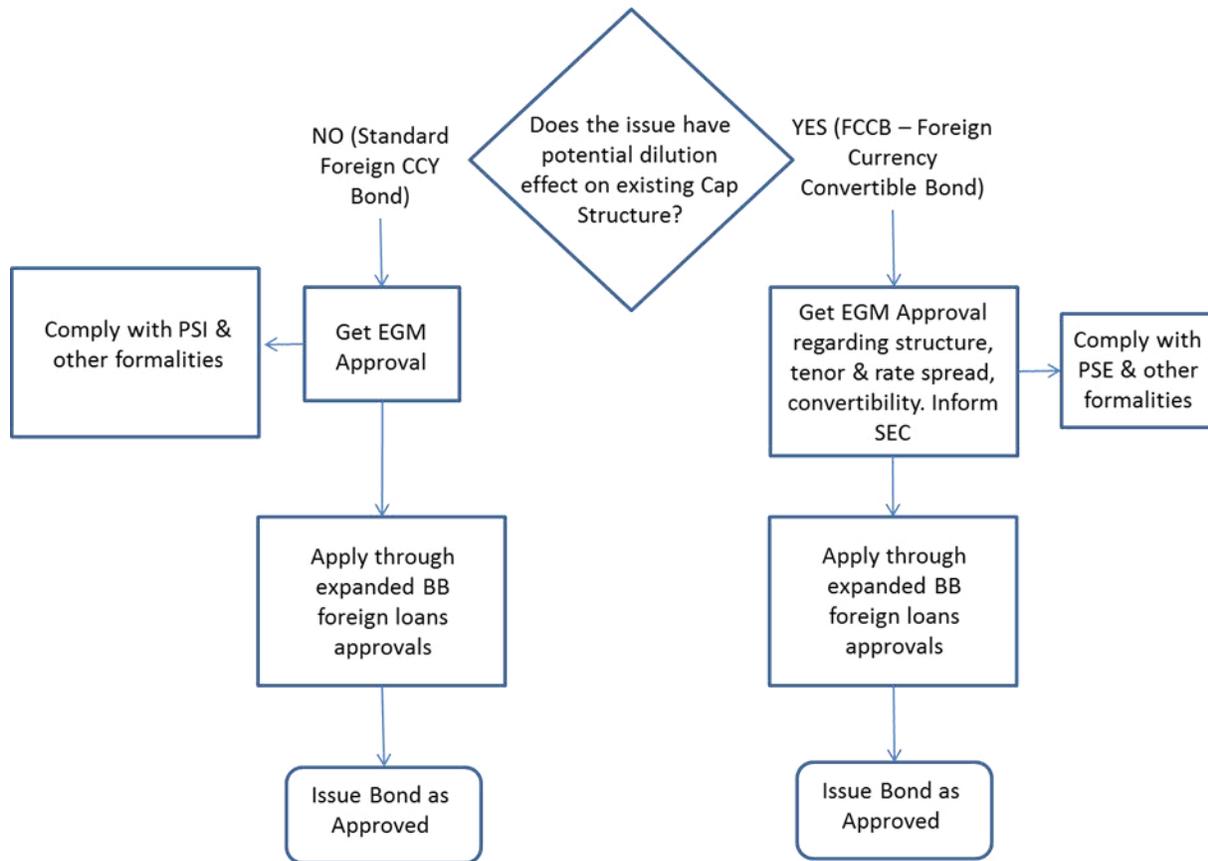
1.15 Policy Recommendations for Foreign Currency Bonds

As confidence in the means of ECB financing has grown, the Indian regulatory framework has adopted an automatic channel for ECB financing where loans and bond issues, as long as they meet pre-defined criteria set by the RBI in terms of who the borrower is, from which sector, the amount and the terms of financing i.e. cost and tenure, are authorized by banks who have been designated “Approved Dealers” by the central bank. The “Approval” route whereby loans need to be individually sanctioned by the Empowered Committee of the RBI is a route only taken when companies don’t qualify for the automatic route, or where companies want to borrow in excess of the limit for the automatic route. The latter seems unlikely since the RBI, in September 2012, actually increased the upper limit for any Indian company want to borrow from the automatic route up to a ceiling of \$ 3bn from the previous limit of \$750mn, subject to certain export criteria being met for industrial companies.

For Bangladesh, we would recommend that foreign currency bond issues are approved by the an enlarged “scrutiny committee” to include members of the BB, BOI, MoF and the SEC and the approval process can be speeded up and streamlined as per the recommendations contained in the recent analysis done by BICF.

For foreign currency denominated bonds we have detailed below two streams - one for a standard foreign currency bond and the other for a FCCB (foreign currency convertible bond).

Figure 6 – Proposed Process Flow for Bond Issue



Firstly, for the standard bond we recommend that this follows the same approval process for foreign loans, requiring approval from an enlarged Scrutiny Committee, rather than it also falling under the jurisdiction of the BSEC. In our view, it does not make any difference in terms of BSEC involvement whether the foreign currency bond issuing company is listed or not. After all they are not involved in foreign currency loans approvals whether the borrower is listed or not. The main issue is whether the instrument itself is listed domestically or not. In the case of a foreign currency bond, it is not listed domestically but rather traded as an OTC (over-the-counter) bond by international dealers. So BSEC has no need for jurisdiction there. While the Securities and Exchange Ordinance, 1969, extract relating to definition of securities, includes loans and bonds as 'securities' that fall under the jurisdiction of the BSEC, in practice loans do not currently require BSEC approvals – and we believe this should also be the case for Standard Foreign Currency Bonds. However we would recommend the BSEC will sit on an expanded foreign currency loans/bonds scrutiny committee within BB.

A more complex issue is for a FCCB (foreign currency convertible bond) which may affect the capital structure of the company. In this situation looking at the Indian rules for FCCB borrowing, RBI still takes regulatory precedence over SEBI. However we would

propose that the FCCB issuing company "needs to inform the SEC". This is different to seeking "approval" from the SEC prior to going before the BB approvals committee. The whole objective is to reduce regulatory bottlenecks and as the SEC will be represented on an expected foreign bond approvals committee, it does not make sense for it to go to them twice even for an FCCB.

At the same time, Bangladesh Bank should also lay out a framework for an automatic approval process perhaps initially for smaller foreign currency borrowing of up to \$50 Million subject to similar criteria as has worked effectively in the Indian regulations. "Approved Dealers" could include the large global banks such as SCB, HSBC and Citi as well as some of the larger and more reputable local commercial banks. Over time, as has been the case in India, a greater proportion of foreign financing approvals would be done through the automatic route versus the approval route. We have proposed an indicative roadmap to increase foreign borrowing limits below.

Indicative Proposed Roadmap for Foreign Borrowing Limits	Year 1	Year 2	Year 3
Total External Commercial Borrowing Limit	USD 1bn	USD 2bn	USD 3bn
Automatic Process Limit	USD 50mn	USD 100mn	USD 150mn

In conclusion, we strongly believe the time is right to accelerate foreign currency borrowing opportunities on a selective basis for critical export and infrastructure sectors to reduce crowding out in the domestic financial system and to take advantage of the greater interest and enthusiasm of global lenders and institutional investors to finance Bangladeshi companies. An effective and well executed strategy by the Government of Bangladesh in facilitating this will, we believe, play an important role in underpinning the next phase of growth and achieving the targets laid out in the 5 year plan.

Conclusions – Why has corporate bond market development been so slow?

We have highlighted above a number of constraints on corporate bond market development in Bangladesh. We would argue that while there have undoubtedly been number of contributory factors, in our view the most important remains the relative lack of sufficient institutional investor base for bonds in Bangladesh. This is also the primary factor limiting the development of the Bangladesh government bond market as well. The absence of a sufficient number of end buyers of corporate bonds means that there is very little liquidity in that market and extremely limited and secondary market activity. As a result most buyers of corporate bonds hold to maturity. This limits the incentive and indeed ability for banks to facilitate the issuance of corporate bonds to actively make markets with two-way prices in those bonds after issuance. This in turn reduces the scope, for example, for corporate bond prices to rally either because of a fall in interest rates or indeed on spread yield compression because of less corporate risk either for the economy as a whole or for the specific sector or even corporate name.

A well-developed and liquid government bond market/yield curve is also important. In addition, the for all the reasons that are generally problematic for the government and corporate bond market in Bangladesh, namely a lack of credit culture, transparency of balance sheet and credible ratings agencies are all important factors, but, we believe, are of second order importance versus the absence of final demand.

However, we see the recent \$300mn USD corporate bond issue by Banglalink as a positive development that will likely encourage further institutional investor base for bonds and high quality corporates to issue internationally as a follow up to the \$ 2.7bn of foreign currency loans Bangladesh Bank has approved. If Bangladesh moves to issue a sovereign bond in 2015 then this will likely attract more foreign investors to the Bangladesh bond market, including corporate issues, which in turn may spur further issuance.

The levels of government savings certificate rates make bond yields less attractive. Another policy action would be to reduce the cost of funding and/or increase the post-tax yield via fiscal action.

Crowding out companies experienced in 2011/12, when they suffered from both a reduced pool of bank credit that was absorbed by the government, as well as a weak IPO market for equity issues, underlines the need to develop the corporate bond market. More important than regulatory changes specific to corporate bonds, however, we believe, much as is the case with the BGBM, the development of the institutional investor base is of crucial importance. Dedicated bond mutual funds will help. But the missing link for both the government and corporate bond market in Bangladesh remains, in our view, the rapid development of funded pension schemes for both the government and private sectors.

APPENDIX 4

THE INSURANCE INDUSTRY

APPENDIX 4: The Insurance Industry

1	Background – A 3-Phased Approach	1
1.1	First Phase.....	1
1.2	Second Phase	2
1.3	Third Phase	3
2	Recent Developments	4
3	Considerations for Potential CMDP III Policy Actions	5
3.1	Enhancing IDRA’s Operational Effectiveness	5
3.1.1	Financial Autonomy	7
3.1.2	Operational Independence	8
3.1.3	Freedom from Undue Political Interference	8
3.1.4	Legislative Amendments.....	9
3.2	Other Areas Requiring Legislative Action.....	10
3.3	Pending Rules/Regulations.....	11
3.4	Reforms Concerning the State-Owned Insurers (SOICs).....	12
3.5	Ensuring Adequate Capitalization of the Insurance Industry – Private Sector	14
3.6	Regulatory Information Data Exchange Facility	15
3.7	Other Areas of Concern.....	19
3.7.1	The Training/Education Conundrum & BAIS	19
3.7.2	Central Rating Committee	20
3.7.3	The Acute Shortage of Actuaries	20

APPENDIX 4: The Insurance Industry

1 Background – A Three-Phase Approach

Under CMDP II, in the Insurance Sector White Paper, 2012, we proposed a 3-phased approach to the development of Bangladesh's insurance sector. The Insurance Sector Policy Paper adopted by the GoB in July 2014¹ largely tracks this 3-phased approach, with one notable exception - the absence of any reference to consideration being given to the privatization of the state owned insurance companies (SOICs).

We have "mapped" the items appearing in our original Master Plan with those in the government-adopted version and while there are some areas requiring further clarification and follow-up, most initiatives, with one notable exception, are accounted for.

The mapping of the government Master Plan against the one proposed in our 2012 White Paper is attached as Annex 1. The principal elements of the 3-phased approach is reviewed below for ease of reference, but the reader is directed to the original White Paper for more comprehensive analysis behind and discussion of these phases.

1.1 First Phase

Our White Paper envisioned that in this phase IDRA would concentrate on identifying companies and practices which are not viable and which pose a systemic risk to the financial sector. In order to achieve this IDRA would need to be given independence from political interference in accordance with IAIS core principles. Companies which are not viable should be dealt with and preferably merged with more viable companies or liquidated. One of our recommendations below addresses this process.

We had indicated in 2012 that this process of consolidation and recapitalization may require additional funds from outside sources (either from outside the industry, directly from the government, or financed through donors) to ensure that policyholders would not be negatively affected by this consolidation. It is an urgent matter that these companies are identified and the solvency deficiencies be quantified. Solvent companies cannot be expected to take over insolvent ones without financial assistance, as this might threaten their own solvency.

Our initial mission detected no systematic efforts being made in terms of industry consolidation. We will examine the issue in more depth during our mission in August/September, but, given the authorization of 11 new companies under public allegations that these may have been politically-motivated, potentially making IDRA's

¹ Available on the web at: <http://www.bfid.gov.bd/Report/bima.pdf>

job of consolidation considerably more difficult (more on this below), we are operating under the working assumption that there has been little, if any measurable progress made in this area.

The White Paper also envisioned IDRA concentrating on activities which are antithetical to a healthy business. This is related mostly to commissions and expenses and inappropriate investment practices. IDRA has started to do this, which is commendable. However, IDRA should avoid micro-managing this process, as this is very manpower intensive and could be achieved by a balance of carrots and sticks.

Insuring the proper functioning of the Central Rating Committee was another initiative we had proposed for this phase of activities. While we are not in favor of the concept of price-fixing as a long-range solution to the problems it has been designed to address, we acknowledged that it may need to continue to exist in the short run, and proposed that it be carefully examined in the first phase to ensure functions properly to produce tariff rates which are reflective of actual risks and provide sufficient income to efficient producers to cover the appropriate level of claims ratio. Rates should not be excessive, which simply protects the weaker companies and does not encourage efficient production. We further proposed that the existence of the CRC should be “sunsetting”, preferably by legislative action.

We envisioned that regulatory financial reporting would also be standardized and that IDRA should begin to computerize the gathering and analysis of the data received.

We proposed that a concerted effort be made in this phase to improve human resources, especially in the actuarial field, so that at least a nucleus of qualified personnel is available as we move into the second phase.

We also proposed that the State-owned Insurance Companies (SOICs) be addressed during this phase by putting them on a commercial basis, replacing non-professional management (i.e. those with no significant insurance backgrounds) with more professional personnel who do have specific experience in the insurance industry, as well as removing the special privileges afforded these organizations that are likely to be producing distortions that effectively “crowd out” the private sector.

1.2 Second Phase

In this phase, we pointed to the need to move to a more modern approach to valuation of liabilities for both life and general insurance. This will be made possible by the increase in qualified personnel in both industry and the IDRA. Similarly, capital adequacy tests should be moved towards a Solvency 1 approach.

It was envisioned that in this stage, IDRA would be moving towards a more risk based approach to insurance regulation. This would be based on both a quantitative assessment of the financial strength of companies, based on the soundness of their financial statements, their technical and actuarial reserves and capital adequacy and on a qualitative assessment of the strength of their corporate governance, risk management, investment management and other areas which pose systemic and individual company risk.

Companies would need to be encouraged to offer more innovative products, distribution channels and client management. This would be encouraged by gradual liberalization of regulatory control and phasing out of the Central Rating Committee in accordance with the "sunset" provision enacted into law during Phase One, and greater market competition in both life and general insurance.

We envisioned that Bangladesh's professional organization for actuaries would be in a better position to fulfill the requirements for full membership of the International Actuarial Association and should therefore apply for such membership during this phase.

We envisioned that a full insurance education program would be in existence, and that such education would include various elements such as underwriting, adjusting, insurance accounting, investment and so on as well as actuarial education. During the Phase One and the beginning of the Phase Two this education might be provided by a mix of Bangladeshi and foreign instructors and/or training in India or elsewhere in the region. By the end of this phase sufficient Bangladeshi insurance professionals should be available to undertake this task themselves.

By this phase insurance penetration and density should be comparable to regional partners such as India, Pakistan and Sri Lanka.

Further consideration could be given to more radical reforms for JBC and SBC, as outlined in the Maxwell Stamp report.

1.3 Third Phase

We envisioned that a key element of this phase would be the move by IDRA towards international regulatory standards and, in particular, towards Solvency 2, or whatever the regulatory standards are by then, given that regulatory standards do not stand still.

Other elements of the third phase are more difficult to articulate, but we had envisioned that generally by this phase:

- Insurance penetration and density would be comparable to those in other countries in the region - including the currently more advanced nations such as Malaysia and Singapore;
- The range of policies would be comparable to the range in currently more developed countries; and
- The image and profile of the industry should be comparable to banks and other financial institutions.

2 Recent Developments

We have approached the insurance component of the project by taking the White Paper and accompanying Road Map we developed in 2012 as our primary knowledge base. Looking at developments since 2012, the most noteworthy are:

- The authorization, in July 2013, of 16 new insurance companies by IDRA, of which 2 are general insurers and 14 are life insurers; and
- The adoption of the Insurance Sector White Paper and Road Map/Master Plan by the government in June 2014 under the heading “Bangladesh Insurance Sector Policy”.²

There are abundant opportunities for growth and expansion in Bangladesh's insurance market. This is evident when one considers the extremely low levels of insurance penetration and density in Bangladesh as compared to some of its neighbors. As further elaborated in the 2012 White Paper we are of the view that barriers to entry tend to protect incumbents and crystalize sub-optimal practices, and that healthy competition is, on balance, good for the industry, in that it stimulates innovation and leads to improved services and lower pricing for consumers.

We believe that companies that are not able to provide consumers with a superior “value proposition” should not be protected from the pressures of the marketplace – rather, that they should be allowed to feel the impact of these pressures, be acutely aware of them, and how changes in their behavior affect the magnitude and direction of these pressures. However, we also feel that having gained entry, companies should be required to hold sufficient levels of capital as a buffer against unanticipated adverse events, and that capital levels should be dynamic – changing with the levels of risk to which the company is exposed.

We consider the adoption of the Bangladesh Insurance Sector Policy in June 2014 as a positive development, and a step in the right direction – one which gets the insurance

² Available on the web at: <http://www.bfid.gov.bd/Report/bima.pdf>

industry a step closer to where it needs to be. We have obtained a translation of the Insurance Sector White Paper. In general it is in agreement with original suggestions in our 2012 paper. Some sections have been rearranged and broken into multiple objectives, while others have been added, as noted in the Annex. The only area which appears to be missing is full privatization of SBC and JBC, but given that this was a third phase objective in our paper, and hence to be achieved in the more distant future, this is not a major omission.

If the adoption of the Insurance Policy achieves nothing else, it will have raised the awareness of the policy makers involved in scrutinizing it - awareness of the magnitude of the opportunities to expand the insurance market, as well as the obstacles to realizing this potential. We consider that to be a positive development in its own right.

In summary, whether the entry of 16 new companies will turn out to be a good or a bad thing for the industry, in the long run, will depend on whether the IDRA is able to develop the above-described environment. While we do not see “eye-to-eye” on every issue with the present Chairman, we believe his assessment of the issues plaguing the industry is spot-on, that his views on the type of environment that needs to be established are quite appropriate, and that he is certainly well-aware of the broad initiatives and the tasks required to achieve this objective. The two BIG questions are:

- Whether the government will play a facilitative role in the process of change that will be necessary to get to that point; and
- Whether the owners of the insurance companies can be coopted as a positive force for change – i.e. whether they can be convinced to put the greater good of the industry ahead of personal interests.

So far, we have not been able to answer either of these questions with an emphatic and resounding “Yes”. We are, however, seeing some indications that this may be changing, and, thus, this may be an opportune time for ADB to be renewing its focus on the insurance industry and its support for the forces for change.

3 Considerations for Potential CMDP III Policy Actions

Below we discuss areas we believe may be “fertile grounds” for producing potential Policy Actions, and offer some specific suggestions.

3.1 Enhancing IDRA’s Operational Effectiveness

As mentioned in our White Paper, and as appears to have been adopted as part of the government’s Insurance Sector Policy,³ an issue of particular importance during the first

³ See strategic initiative (SI) 12, Strengthening of IDRA, which explicitly specifies “Ensuring operational independence” and “Arranging [for] sufficient funds” as two of the specific goals of this SI.

phase is to ensure operational independence and a secure source of funding for IDRA, as set out in the International Association of Insurance Supervisors (IAIS) core principles. IDRA also needs the ability to issue rules and/or regulations under its own authority. This would enable it to respond quickly to changing circumstances and emerging risks in a manner that is free from undue political, governmental, and industry interference.

IAIS Core Principle 2.4 (IAIS CP2.4) lays the foundation for supervision of the insurance sector. It states:

"The supervisor and its staff are free from undue political, governmental and industry interference in the performance of supervisory responsibilities. The supervisor is financed in a manner that does not undermine its independence. The supervisor has discretion to allocate its resources in accordance with its mandate and objectives and the risks it perceives."

Compliance with this Core Principle is the starting point for the effective supervision of the insurance industry.

IDRA plays a key role in regulating the market in order to ensure that best practices are adopted by insurance companies, that they remain solvent and protect consumers. It also plays a vital role in development of the insurance industry. It cannot fulfill this mandate unless it is free from government interference and has operational independence. At the present time, the lack of independence stems from its:

- Lack of independent authority to make rules and regulations;
- Lack of independent authority over its fund (i.e. although the IDRA Fund exists, IDRA has no *independent spending authority, as its budget is subject to government approval*);
- Lack of independent authority to conduct its own procurements of the goods and services it requires to operate effectively;
- Lack of independent authority to determine the salary of the Chairman and Members of the IDRA;
- Arrangements that allow the government to exert its will upon the Chairman and Members;

This is inconsistent with the powers conferred on insurance regulators in other jurisdictions as well as other regulatory agencies in Bangladesh.

A further concern expressed in relation to this issue concerns the eventual replacement of the Chairman when his final term comes to an end in two years' time. Given the lack of skilled insurance professionals in general, and actuaries in particular, and the gap between remuneration packages at IDRA and the industry, the concern is that a

suitable replacement might be difficult if not impossible to find. At the very least, consideration should be given to mirroring the BSEC and Bangladesh Bank with respect to salary and benefits and other terms and conditions (such as two consecutive four year terms for Members/Commissioners in lieu of the current three). Enhanced status of the Chairman in relation to his standing in the government hierarchy would also assist in this regard.

3.1.1 Financial Autonomy

Section 16 of the IDRA Act requires IDRA to be financed through a fund (the "IDRA Fund") to which money may be deposited from government and other grants; as well as insurer registration fees, fines levied on insurers, a specified portion of insurers' premium income, fees from appointment of insurance brokers, insurance surveyors and insurance agents, among other sources.

All remuneration, salary, allowances etc. of IDRA's Chairman, members, officers and employees as well as other IDRA expenditures must be paid out of the IDRA Fund. However, IDRA does not have the discretion to allocate its resources in accordance with its mandate, objectives and the risks it perceives. Section 17 of the IDRA Act makes IDRA's budget subject to government approval. IDRA cannot retain any balance in the IDRA Fund. Any surplus remaining in the IDRA Fund after covering IDRA's annual expenditures must be deposited in the government treasury pursuant to the government's direction. While we have not independently verified this, we have been advised that IDRA has sufficient funding from non-government sources to provide for an independent and secure funding base, and does not require government funding to operate effectively (i.e. that it is, on balance, a "net contributor" to the government treasury).

We understand that the government may find it difficult to extend the privilege enjoyed by BSEC (i.e. the ability to retain "surplus" funds) to other regulatory agencies. In which case, we would suggest that the formula for levying the industry be modelled on the approach used by the Office of the Superintendent of Financial Institutions (Canada) and other self-supporting regulatory agencies. The model is as follows: IDRA establish a budget, including operational expenses and amortized capital expenditures. This is the numerator. The denominator is some aggregate, such as total industry assets at the previous year end. The division of the numerator by the denominator provides a factor which can be applied to the given aggregate in future years to calculate the level of fees necessary to cover IDRA's expenses and capital expenditures. This calculation is updated in future years to ensure that IDRA collects approximately its running expenses and capital expenditures over time. To collect more than this and return the "surplus" to the government represents hidden taxation - an excessive burden on the industry,

which believes itself and its policyholders (in the life branch at least) to be over-taxed in any event.

3.1.2 Operational Independence

IDRA is presently constrained with respect to its ability to hire staff and procure the office facilities, equipment and other goods and services it requires to carry out its mission of regulating the insurance industry. Decisions on staff composition and compensation are subject to prior approval by the government (Ministry of Public Administration and Ministry of Finance) through the process known as the Table of Organogram and Equipment (TO&E)

Operational independence should include the authority to determine its staffing levels, pay scale and other benefits in a manner that would allow it to attract well-educated, well-trained and experienced staff. IDRA will have to compete with the private sector in attracting qualified staff, so the benefits it offers prospective staff will have to be competitive - at least equivalent to other financial market regulators (e.g., BB and BSEC). Furthermore, IDRA should be authorized, under delegated authority from the government, to procure the goods and services it requires in the course of its business, and to support its regulatory agenda.

3.1.3 Freedom from Undue Political Interference

The Insurance Development Regulatory Authority Act, 2010 (IDRA Act) does not adequately provide for IDRA's freedom from undue political interference. Section 14 (Removal) permits the government to remove the Chairman or any Member, if it finds they have acted in a manner that is "detrimental to the Authority", or if either have administered themselves in such manner or abuses his position that "hinders the purpose of the IDRA Act or the public interest".

Further, Section 31 permits the government to issue binding directives to IDRA. Section 29 authorizes the government to make rules to carry out the purposes of the Act. Section 30 permits IDRA to make regulations, but only subject to pre-approval of the government. Sections 146 and 148 of the Insurance Act, 2010, provide similar government power to make rules and require preapproval of IDRA regulations by the government. Section 147 of that Act allows the Government to amend schedules.

In order to address the above deficiencies in the IDRA and Insurance Acts of 2010, we are recommending the following legislative amendments to enhance IDRA's independence, allow conformance with the IAIS CP2.4 and provide it with:

- Rule-making authority
- Financial autonomy

- Delegated procurement authority

3.1.4 Legislative Amendments

Because IDRA's financial autonomy and operational independence are constrained, and it does not fully enjoy freedom from undue political interference, as required by IAIS Core Principle 2, its ability to function effectively is constrained. In accordance with CP 2.4, we would propose the *following amendments to the IDRA Act, 2010* to permit IDRA to become financially autonomous and operationally independent, and to insulate it from undue political interference:

- Section 10 Sub-section 2) requires the appointment and other terms and conditions of service of officers and employees of the Authority to be determined by government rules. A new Sub-section 3 should be added to Section 10 that states (similarly to Section 9 of the Securities and Exchange Act, 1993, as amended in December 2012), "(3) Under sub-section (2), service conditions of the officers and employees of the Authority may be determined in line with the salaries, allowances and other benefits provided to the officers and employees of Bangladesh Bank."⁴
- Section 16 establishes the IDRA Fund from government grants and other sources. Subsection (4) that requires full or part of any surplus sum that may remain after incurring the expenditure of the Authority for the concerned financial year is to be "deposited in the government treasury pursuant to government direction" should be deleted and a new subsection substituted that states, "(4) Notwithstanding anything contained in subsection (3), with the exception of the grants received from the government, local authorities or any other institutions as described in sub-section (1), the Authority may use moneys earned by it for its own purposes.
- Section 17 that requires the Authority to submit its annual budget to the government for approval should be deleted and a new Section 17 should be substituted that provides: "ANNUAL BUDGET STATEMENT - The Authority shall submit to the government, within the time as may be determined by the government, its annual budget statement for the upcoming financial year mentioning the amount of money required from the government in that financial year."

⁴ SEC Act, Section 9, APPOINTMENT OF OFFICERS AND EMPLOYEES, states: "1) As per organogram approved by the Government, the Commission may appoint such officers and employees as necessary for discharging its functions properly. (2) Terms and conditions of the services of officers and employees of the Commission appointed under sub-section (1) shall be determined by the rules. (3) Under sub-section (2), service condition of the officers and employees of the Commission may be determined in line with the salaries, allowances and other benefits provided to the officers and employees of Bangladesh Bank."

- Subsection 3 of Section 20 which authorizes the government to “at any time, direct that an investigation be conducted on activities of the Authority or in relation to any kind of allegation” should be amended to authorize the government to direct an investigation only for “just cause on reasonable suspicion that misconduct has occurred or may be occurring, but only with respect to such possible misconduct.”
- Section 29 that authorizes the government, by notification in the official Gazette, to make rules to carry out the purposes of the Act, should be amended to substitute “the Authority” for “the government.” Section 146 of the *Insurance Act* which is to the same effect (but specifically mentions rules as to different matters including Islamic insurance under that Act, should also be amended by substituting “the Authority” for “the government.” Implementation of this recommendation would provide IDRA with rulemaking power similar to that of securities market regulatory authority, the BSEC.⁵
- Section 30 (Power to make Regulations) which authorizes the Authority,” subject to the pre-approval of the government,” by notification in the official Gazette, to “make regulations to carry out the purposes of this Act”, should be amended to delete the phrase, “subject to the pre-approval of the government.” Section 148 of the *Insurance Act* which is to the same effect should be amended in the same manner, by deleting the requirement of pre-approval by the government.
- Section 31, which authorizes the government to issue “special directives” to the Authority for the purposes of the Act, and the Authority to be bound by those directives, should be deleted.
- Section 147 of the *Insurance Act* which allows the government by notification in the Official Gazette to amend schedules as it sees fit should be deleted.

3.2 Other Areas Requiring Legislative Action

Other areas requiring legislative amendments are as follows:⁶

- Amending the *Insurance Act* to repeal the maximum commissions and maximum expenses provisions (sections 58 & 62). Recognizing that it may indeed be

⁵ The Securities and Exchange Ordinance, 1969, (Ordinance) Section 33 Power to make rules (1) and the Securities and Exchange Act, 1993 (SEC Act) Section 24, Power to make rules (1) each authorizes the BSEC, by notification in the official Gazette, to carry out the purposes of the respective acts provided that rules proposed are published in 3 newspapers of wide circulation (2 in Bangla and 1 in English) inviting opinion, advice and objection. In special cases, where it is not appropriate to invite opinion, the BSEC, may, after consultation with the government, make the rules by publication in the Gazette. The one exception under SEC Act, Section 24 (3), is that the BSEC cannot prepare or amend rules regarding service condition without prior approval of the government.

⁶ There may be other areas, such as the removal of conflicts with other legislation (i.e. the law governing microfinance apparently allows MFIs to offer insurance products, and may need to be reconciled/rationalized)

necessary to cap commissions and expenses in the short run, we propose addressing these limits through regulation. Ultimately, these should be market-driven.⁸ Permitting lower cost distribution channels, such as *bancassurance* and direct marketing, will be a more effective approach to reducing costs than legislated maxima, which appear to be ineffective in any event.

3.3 Pending Rules/Regulations

Our principal recommendation with respect to regulations is mentioned above – it is for the IDRA to be authorized, by statute, to promulgate and issue the rules and regulations required for it to effectively supervise the insurance industry. However, until such time as the legislative initiatives are completed, the regulations, some of which that have been pending for lengthy periods, need to be adopted post haste as the absence of regulations – especially in key areas such as capital adequacy – is preventing the implementation of a number of key initiatives envisioned in the Insurance White Paper (and presumably also by the government's Insurance Policy Framework) designed to strengthen the industry and place it on a firmer footing. For example, without a minimum capital rule it would be difficult to require insurers to meet regulatory capital requirements – one of the first steps in helping the industry to strengthen its financial condition. Where up-to-date regulations are missing the industry may be obliged to comply with 1958 regulations, some of which contradict the Act.

We recommend that the government clear all of the pending insurance regulations that have been in the "pipeline" for 90 days or longer, or, if it has any concerns, to immediately communicate the reasons for its concerns to the IDRA so that it may consider the government's views in finalizing the regulations. 90 days should provide the government with sufficient time to review and provide its comments on insurance regulations. ADB may consider including this as a First Tranche Policy Action for the CMDP III Policy Loan.

At a minimum, we would propose that the following regulations be adopted immediately (which we are informed have been drafted and have been pending final approval from either the Ministry of Justice or the Ministry of Finance for a considerable length of time) These include the regulations on:

- *Paid-Up Capital and Share Holdings of an Insurance Company* – this is most important and urgent, to permit the consolidation phase (Phase 1) to get underway.

⁸ Refer to Insurance Sector White Paper, 2012 for a more complete discussion of the rationale for this.

- *Appointment of Consultants or Advisors* (by IDRA) – this too is an important rule/regulation as it will allow IDRA to engage, as consultants/advisors a wide range of specialized expertise that is critical to its success as a regulator, but is not likely to be able to engage on a full time basis as part of its staff.
- The three related regulations concerning *Licensing Brokers; Licensing Life Insurance Agents; and Licensing Non-Life Insurance Agents* - These “agents” are the source of much of the business insurers are writing, and are also the source of many of the problems ailing the industry. Enhancing the quality and professionalism of brokers and agents can go a long way toward addressing some of the industry’s fundamental problems/challenges.
- The two regulations addressing reinsurance – *Reinsurance for Life Insurance Business in Foreign Countries, and Reinsurance for Non-Life Insurance Business in Foreign Countries*. As mentioned in the White Paper, foreign reinsurance has several benefits for the industry that would tend to improve standards and mitigate risk.
- *Life Insurance Policy Holders Protection Fund (PHPF)* – while the establishment of a policy holders protection fund may be somewhat premature at this stage, this is a longer term objective of the White Paper/Road Map and putting in place the regulatory framework would clarify the nature of the Fund and permit stakeholders to anticipate, and plan for, the eventual establishment of a PHPF.

3.4 Reforms Concerning the State-Owned Insurers (SOICs)

The White Paper/Road Map recommended a program of reforms for Jiban Bima Corporation (JBC) and Sadharan Bima Corporation (SBC) – i.e. the state-owned insurance companies (SOICs). During Phase 1 of the Road Map, it was recommended that the business operations of these two SOICs be rationalized and that they be “commercialized”, and it was envisioned that they would be operating entirely on a commercial basis by the end of Phase 1. We would recommend that MoF, working in close coordination and collaboration with, and receiving advice from IDRA, develop and adopt an approach and plan to commercialize both SOICs. We suggest that ADB may consider supporting the process of commercialization by adopting one or more of the recommendations set forth below as Policy Actions. This would set the process of commercialization in motion and serve to break through the “policy inertia”.

Determining the true financial condition of the SOICs - As a first step, we would want to determine the true financial condition of the two SOICs including:

- The adequacy of their technical (and other) reserves; and

- The adequacy of their (regulatory) capital as calculated in accordance with the regulation on capital (which, as mentioned above, has been pending government approval – the rapid adoption of this regulation is emphasized).

The financial statements of the SOICs are poorly prepared and inadequately audited. The true financial condition of the SOICs should be determined through an independent evaluation done by a qualified chartered accounting firm. This may require recasting their financial statements (in accordance with the standards to which insurance companies in the private sector are required to adhere). In the case of JBC, an up-to-date actuarial analysis should also be undertaken in conjunction with the review of its financial condition. This exercise will provide policy-makers a basis on which to assess the available options for commercialization.

Developing a credible "capital restoration plan" to bridge the solvency gap - The above exercise is likely to reveal that one or both of the SOICs are undercapitalized, and, in the case of JBC, possibly even technically insolvent. As part of the assignment, the consultant engaged to perform the assessment of financial condition could also be tasked with recommending a "capital restoration plan" for the SOICs that would plug the shortfall in regulatory capital over a reasonable (i.e. 3-year) time frame. The adoption of this capital restoration plan by the government could be considered by ADB for inclusion as a Second Tranche Policy Action (depending, of course, on the timing of the engagement of the valuation consultant).

Developing and implementing a commercialization plan – A plan would need to be developed to put the SOICs on a fully-commercialized basis within a specified (i.e. 5-year) time frame. This would include:

- A "subsidy/privilege phase-out plan" – for the two SOICs which would remove all of the privileges afforded to SBC & JBC over a reasonable time frame (i.e. 3 years) to "level the playing field" with respect to the private sector insurers and serve to remove the distortions being created as a result of these subsidies and privileges;
- A corporate governance plan – which would eliminate political/government influence and hold an independent board and management accountable for the performance of the SOICs;
- A business restructuring and reorganization plan – for each of the SOICs that reviews and assesses all of the business/product lines of each entity with a view to re-focusing the organization on those lines in which it enjoys (or can develop, within a reasonable time frame) a competitive advantage. This business reorganization plan would also include a plan for reorganizing and staffing each

of the SOICs as a profit-seeking commercial operation in accordance with best practices and commercial principles; and

- *A dynamic, market-oriented human resource development plan* - which aims at replacing - over a 5 year period - all of the civil servants presently holding office at the SOICs with professional staff recruited from the insurance industry, and includes, among other things an appropriate, market-driven compensation policy and pay structure, and a human resource strengthening and capacity development plan for the employees of the SOICs.

3.5 Ensuring Adequate Capitalization of the Insurance Industry – Private Sector

The White Paper/Master Plan recommended that the IDRA adopt and implement a plan of action to ensure an adequately capitalized insurance industry. Unfortunately, a program to recapitalize the industry has been “held captive” by the bureaucratic processes involved in the present rule-making arrangements (see discussion above regarding the crucial need for providing IDRA with full rule-making authority), as one of the key elements of such a program (the capital rule) is pending government approval. Thus, IDRA’s efforts, which have been largely at the margin, have yielded limited results and the principal effort to move the industry toward more appropriate levels of capitalization has been thwarted by IDRA’s lack of rule-making authority.

Assuming that the logjam of pending rules/regulations is broken, and that the capital rule is adopted as a result of a First Tranche Policy Action, IDRA will need to design and adopt a plan to improve the solvency of the industry by requiring that all insurers meet the minimum reserve and regulatory capital requirements within a specified time frame (i.e. by 2018). This would entail the following steps, among others:

Evaluate level of confidence in financial statements - A first step would entail a “first-instance review” by IDRA of the insurers’ financial statements and regulatory filings to identify those insurers that may be at the greatest risk of being inadequately capitalized. Such a review should include an evaluation of the companies’ audited financial statements and an assessment of the quality of the companies’ external auditors, based on the qualifications, professional certifications, and market reputation of the firms (and perhaps more importantly of the individuals) involved in conducting the insurer’s external audit. The primary objective of these assessments would be to determine a level of confidence (based on an objectively determined and consistently applied methodology that might result in a “confidence index” for each insurer) that they present a true and fair view of the firms’ financial performance and condition, which could be based on both qualitative and quantitative key indicators of risk. It is likely that IDRA would require external assistance from a qualified auditor - as there appear to be none on staff - to make this determination, thus, the critical importance of

expediting the adoption of the regulation on “Appointment of Consultants or Advisors” mentioned above.

Determine minimum regulatory capital requirement - The second step would be to calculate the regulatory capital requirement (and surplus/deficit) for each insurer in accordance with the capital adequacy standards. For those insurers that are associated with a low confidence index, this second step would entail a requirement for the insurer to *engage a qualified firm of chartered accountants (or a qualified individual auditor)* from among a pre-vetted list of approved firms/individuals provided by the IDRA to examine the firm's books and records and financial statements and, if required, to recast the insurer's financial statements to more accurately represent the firm's "true" financial condition. IDRA would need to calculate the regulatory capital for all firms on a similar basis in accordance with (IAS/IFRS or BAS).

Develop and implement capital restoration plans – The next step would be for IDRA to require those insurers whose regulatory capital is below the minimum required by the newly adopted capital rule to submit to the IDRA by a certain date (i.e. 6 months from the time it is directed by IDRA), for its approval, a credible, time-bound plan to raise capital (“capital restoration plan”) to the minimum level required over a period of 3 years, with agreed milestones along the way and clarification of the remedial actions likely to be taken by IDRA for failure to meet the capital requirements within the agreed timeframe, which could include - depending on the remedies available to IDRA under the Insurance Act 2010 - the appointment of an Administrator to develop and execute a “resolution plan”.⁹

We would suggest that the ADB consider including one or more elements of the above process as Policy Actions under CMDP III, and consider requiring the adoption by IDRA of a capital adequacy program along the lines described above as a First Tranche Policy Action (T1PA), and the execution of capital restoration plans with those insurers found to have capital deficits as a Second Tranche Policy Action (T2PA)

3.6 Regulatory Information Data Exchange Facility

The White Paper/Master Plan contains a recommendation that the IDRA adopt/implement an electronic data exchange and data warehouse to facilitate:

- The submission by regulated entities of regularly required information (“returns”); and
- The analysis by IDRA of the information contained in these returns as a part of its off-site monitoring and supervision of the insurance industry.

⁹ Note: IDRA may seek external legal advice on the manner in which to structure the “capital restoration plans” in order facilitate any remedial actions necessitated by the failure of an insurer to adhere to its provisions/requirements

In our meetings with IDRA, a strong interest has been expressed in going further than this recommendation, and a suggestion was made to explore the possibility of IDRA operating a centralized business automation (front and back office) system/application and providing fee-based access to this system on a “cost recovery” basis. The argument made in favor of this type of an arrangement is that it would:

- Increase standardization (of practices, documentation, disclosure, etc.) across the industry, leading to improvements in post-sales customer service, a better “value proposition” for the consumer and improving the image of the insurance industry among consumers;
- Increase transparency in the industry as a result of the automation of all transactions and audit trails, making it difficult to circumvent rules and regulations, especially those related to controls on pricing, commissions and expenses, the avoidance of some of which have created perverse incentives and practices – i.e. setting up fictitious agents/intermediaries to circumvent such limits, a practice detrimental to the industry as a whole and to its public image;
- Facilitate enforcement of rules and regulations, making it easier for the IDRA to investigate and prosecute malpractices; and
- Provide a cost-effective alternative to each company having to acquire their own business automation systems at a high cost that may be prohibitively expensive especially for the newly-authorized companies and some of the smaller ones that are largely operating with manual systems.

We were informed that such a centralized system has been implemented by the insurance regulatory authority of Malaysia. While the benefits cited by IDRA may indeed be achieved by implementing such a system, and such improvements may indeed inure to the benefit of the industry as a whole, as long as the environment remains highly prescriptive and administrative controls prevail, perverse incentives will tend to persist, and, in our view, it would only be a matter of time before the unscrupulous actors would discover ways and means to circumvent even the most “fail safe” automated systems.

Furthermore, the operation of an industry-wide system would pose significant technical challenges that an organization in its infancy, such as the IDRA, may find difficult to navigate successfully, not to mention the thorny issue of potential conflict of interests to which such an arrangement might give rise. On balance, our initial reaction is to take a cautious stance on this proposal.

However, the recommendation made in the White Paper/Road Map is one that we continue to support and would recommend ADB consider supporting the establishment of an information exchange facility for the insurance industry similar to the electronic

data gathering and retrieval (EDGAR) system we are proposing for the BSEC. The central element/component of such a system would be a portal through which insurance companies can fulfill their initial registration and regular filing/reporting obligations. This reporting interface would, after performing some simple validation of the information submitted, transmit the data into a central database/warehouse which would be accessible by authorized staff of the IDRA for monitoring the financial performance and health of the industry.

As further elaborated in the White Paper, a decision support system (DSS) could manipulate the information stored in the data warehouse in such a manner as to identify those entities that pose a higher level of risk to themselves and to the system as a whole. The development of a system of risk based supervision was envisioned by the White Paper/Master Plan as a Phase 2 activity, but it would be beneficial to have the “plumbing” in place well before the RBS is implemented as this can have a positive impact on the IDRA’s regulatory capacity (and, potentially on the broader industry) in its own right. Some of the benefits of implementing such a system are:

- The immediacy of the data and the ability to manipulate it with minimal effort would enable the IDRA to spot emerging trends; to be more responsive in reacting to, and addressing emerging issues of concern; allow it to take swift action to avoid the accumulation of risks that may otherwise rise to systemic proportions and become more problematic; and
- The availability of information to support regulatory policy decisions on a near real-time basis

Requirements analysis - As a first step the IDRA would need to define and document its requirements. This can be done internally (if the capacity is available) or contracted to an external consultant/vendor (adoption of the regulation on the “Appointment of Consultants and Advisors” mentioned above is critical in this respect).

Request for Proposal (RFP) – Once IDRA’s requirements are analyzed and documented, an RFP will need to be issued for the hardware and software required. It would be advisable to utilize, to the extent feasible, off-the-shelf products that can be easily and cost-effectively maintained. Developing software from “scratch” is a costly affair that usually runs into cost and time overruns. In this step an evaluation approach and methodology will need to be developed resulting in an evaluation criteria, and an evaluation matrix/scorecard.

Response evaluation and vendor selection – Responses received will need to be evaluated by the designated evaluation team/committee, and these evaluations will need to be compiled and consolidated into a final evaluation and a decision

announced based on the results of the final evaluation. The decision will need to be announced and a contract will need to be executed with the successful bidder.

Monitoring development, acceptance testing and overseeing installation – Once vendor selection is finalized, an IDRA team will need to monitor/oversee the vendor during the “development” stage. Any changes to the requirements will need to be communicated to the vendor and changes will need to be reflected in the change log. Once the system is ready to be user-tested, the IDRA project team will need to arrange for “scripts” to test the system under various likely scenarios. If/when the system passes all user tests, it is ready to deploy, and an IDRA team, working with the vendor will need to ensure that the vendor delivers all of the training modules/sessions for which it was contracted. Finally, the IDRA project team in collaboration with IDRA's internal IT Department (if there is no such department/function, an external expert may need to be engaged at this to oversee acceptance testing and implementation.

While this would seem to be a simple and straightforward process, IDRA may be constrained in implementing it. As IDRA is currently subject to prior approval of expenditures, moving forward with this initiative on a self/internally-funded basis may not produce optimal results. The ADB, therefore, may wish to consider providing some assistance to enable the acquisition and adoption of this tool on an accelerated basis.

The key elements of this system as envisioned by the team are:

- An offsite supervision (regulatory) database of quantitative and qualitative data collected from regulatory filings submitted by insurers;
- An online real-time module that would allow for the electronic submission of regular reports and filings by insurers;
- A data warehouse (DW) that would store all relevant information and grant access various internal users throughout the organization to obtain up-to-date information required in the day-to-day regulatory operation of IDRA;
- A reporting module that would allow for regularly-recurring and ad-hoc (one-time) reports on the insurance industry; and
- A decision support system (DSS) designed to capture and report on the quantitative information required to develop a "regulatory attention index" which will be the basis for the risk-based supervision envisioned in Phase 2.

Other productivity-enhancing tools to consider including in this initiative (the addition of which would not increase the cost considerably) are:

- An electronic enterprise communications system that includes email, electronic faxing, and (possibly) web-based video conferencing, and collaboration applications; and
- A business process automation (BPA) application that automates routine tasks such as broker authorization/certification, license renewals, enforcement case automation and tracking etc.

3.7 Other Areas of Concern

Two other areas of concern are the fixed & centralized pricing approach in use in Bangladesh for general insurance products (a process referred to as “tariffication”), and the significant shortage of local actuaries. These issues are interrelated, in that the need a Central Rating Committee (CRC – the committee mandated by the Insurance Act and authorized to set pricing for the general insurance industry) is likely to have been caused and is likely being perpetuated (at least partly) because of the shortage of locally resident actuarial talent in Bangladesh.

3.7.1 The Training/Education Conundrum & BAIS

Many of the ills plaguing the insurance industry can trace their roots to the low capacity of industry participants. The dearth of personnel with industry-specific knowledge and experience is a major factor constraining the development of the industry. Insurers are reluctant to provide this training as it possesses some of the characteristics of a “public good” and is prone to the “free rider” problem. This is where one company incurs the expense of training only to lose its trained personnel to competitors offering marginally better compensation to obtain a well-trained employee at no/little expense.

The Bangladesh Academy for Insurance Studies (BAIS) would offer a solution to the “free rider” problem were it not for the “agency” problems with which it is plagued. BAIS is a relic of the nationalized era. It was established during the time when the insurance industry was completely nationalized and designed to serve that industry. Its governance and funding arrangements are not conducive to serving an industry that is dominated by private sector insurers. The Maxwell Stamp report of 2010 offers a solution that would be workable if there were the “political will” to see it through. We have had limited opportunities to explore this with the principal stakeholders, but given the fact that training and education are widely recognized by all industry stakeholders as the top binding constraints to the development of the industry, we would venture to guess that such reforms will not occur “naturally” (i.e. “market failure”)

As such, this initiative may be one worthy of ADB support *in spite* of the absence of “political will”. Our view is that the successful resolution of the “training/education conundrum” would have a considerable positive impact on the development of the

insurance industry, and thus raise this issue for the consideration of the government and ADB. The path to resolution of the “training/education conundrum” may require legislative amendment and may involve disabusing certain powerful interest groups of some of the privileges they currently enjoy. Proposals have been recently made by the government for reform of this institution, which we understand IDRA has found unsatisfactory.

3.7.2 Central Rating Committee

As mentioned above, the 2012 Insurance Sector White Paper sets forth three phases for the development of the insurance industry. While we are not in favor of centralized price-setting for the insurance industry as a long-run solution, we acknowledged that tariffication may be unavoidable in the very short run, but that measures should be instituted to address the problems that are making tariffication unavoidable. We had also envisioned that measures would be instituted to ensure that, in the meantime, the Central Rating Committee functions properly to produce tariff rates which are reflective of actual risks and provide sufficient income to efficient producers to cover the appropriate level of claims ratio. Rates should not be excessive, which simply protects the weaker companies and does not encourage efficient production. The existence of the CRC should be sunsetted in the legislation.

There is general consensus among industry participants and the IDRA that phasing out the CRC is the correct way to approach this issue. It is suggested that this be done line by line¹⁰, starting with the smallest lines by volume of business. In this way any potential problems can be identified in areas which have the least impact.

3.7.3 The Acute Shortage of Actuaries

There is a significant shortage of actuaries in Bangladesh. This is resulting in the inability of insurance companies to calculate reserves and premiums on a scientific basis. It also makes it difficult for IDRA to mandate greater actuarial input into these functions. IDRA itself needs access to both life and non-life actuaries to allow it to assess the appropriateness of such reserves and premiums and as IDRA moves towards international standards of capital adequacy, it will need to have its own actuaries capable of analyzing risk based capital for insurance companies.

The Road Map presented in 2012 analyzed some of the impediments to a more vigorous and viable actuarial profession. Moving forward, appropriate measures to rapidly grow the profession in Bangladesh would need to be explored. However, it is important to note that educational efforts are not enough to anchor the professional successfully in the financial sector. Opportunities for graduates need to be made

¹⁰ A “line” in insurance parlance is an insurance of a particular hazard, such as marine hull, motor insurance, property, etc

available in insurance companies and IDRA, otherwise many of the graduates will be unable to find employment in their chosen field and this will reduce the prestige of the profession. This means that legislation may need to be amended to ensure that actuarial input is a requirement for calculating premiums, reserves and capital adequacy for both life and non-life insurance companies and the removal of various arbitrary percentages for some of these quantities, thus creating demand for such professionals.

The international actuarial community might be able to help in enhancing the actuarial profession in Bangladesh. The Institute and Faculty of Actuaries (IFA) in the United Kingdom is providing assistance to developing countries (for example in Ghana) and available assistance from IFA and other similar international institutes should be explored. Alternatively ADB consider financing the development of an actuarial syllabus and promotion of teaching efforts in a qualified educational institution in Bangladesh. The consultant participated in a project in Bosnia and Herzegovina financed by the European Union Delegation, a component of which was to strengthen the actuarial profession in the former Yugoslav republic. These two approaches are not mutually exclusive and there might be value in combining the two.

Some industry representatives have concerns about the “restrictions” on the use of foreign actuaries. Such concerns might be due to lack of communication of IDRA’s requirements in this regard rather than real impediments. In fact some of the requirements (such as those relating to employment of non-residents and taxation issues) are beyond IDRA’s control and would apply to any non-residents seeking to work in Bangladesh. Other more specific requirements relate to the actuary’s presence in Bangladesh to undertake the appropriate validations and availability for discussion with IDRA. At present, such requirements are communicated by way of letters to companies seeking to utilize non-resident actuaries, but it is suggested that in the interests of greater disclosure and transparency such requirements should appear on the IDRA’s website, clearly stating which requirements are general ones outside of IDRA’s control and which ones are promulgated to ensure that IDRA can be satisfy itself as to the quality of the actuarial work. IDRA has responded positively to this suggestion.

3.8 Agency Status & Name

There is some suggestion that there is a distinction in Bangladesh between an “authority” and a “commission”, with the latter enjoying more autonomy than the former. We cannot corroborate this, but given IDRA’s preference in this matter, we would recommend that consideration be given to elevating IDRA to the status of “commission” – i.e. the **Insurance Development and Regulatory Commission (IDRC)** – may be considered when other suggested legislative amendments are made in due course.

3.9 Taxation Issues

The industry has expressed concern about a number of taxation issues, leading to a feeling that they are taxed excessively and some of the items are a disincentive to development of the industry. These issues include:

- A recently introduced tax on insurance proceeds in life insurance (apart from death claims) of 5% of the excess of the proceeds over the sum of the premiums. No relief appears to be given to past accumulations, so this would amount to retroactive taxation
- A 5% “withholding tax” on agents’ commissions. While in theory this can be offset against income tax owing, many agents’ earnings will fall below the income tax threshold and this withholding tax is not refundable; this is a tax burden that does not fall on other occupations
- A high rate of taxation of corporate profits (this applies to other financial institutions too)

Taxation of insurance companies and their policyholders is complex, but in view of the apparent anomalies brought to attention by industry participants, we would recommend that a study of this issue be undertaken.

3.10 Other Miscellaneous Initiatives

The industry has suggested a number of areas which need developing, which are either missing in Bangladesh, or underdeveloped as compared to the situation in other countries. These include:

- Index insurance for weather and other agricultural hazards – this is a complex area and needs cooperation with the Agriculture Ministry to install monitoring stations and so and probably needs to be subsidized to be viable. We need to draw on ADB experience in other countries to assist in implementing this
- Fund for uninsured and unidentified drivers – Bangladesh lacks this fund, which is common in other jurisdictions. Lack of this fund compromises confidence in third party liability motor insurance
- Awareness and confidence building initiatives – the industry has a poor reputation (unfortunately, sometimes well-deserved) – once we have cleaned up the industry by undertaking the various initiatives indicated above, we need to undertake a public awareness campaign to enhance visibility of the industry and public confidence in it

Annex 1 – Mapping of Objectives: CMDP II Insurance Roadmap vs GoB National Insurance Policy Roadmap

Below is a “mapping” of the strategic initiatives (SIs) presented in the roadmap to the national insurance sector policy announced by the Government of Bangladesh in late July, 2014. We have mapped each of the SIs in the national policy to the initiatives set forth in the roadmap to the Insurance Sector White Paper we developed in 2012 as part of CMDP III. The full document (available only in Bangla) can be downloaded from the website of the Ministry of Finance (Department of Finance) by clicking [here](http://www.bfid.gov.bd/Report/bima.pdf), or by navigating to the following address:

<http://www.bfid.gov.bd/Report/bima.pdf>

Notes:

1. Many of the issues marked “not specifically mentioned” will come about as a result of IDRA’s implementation of the Insurance Core Principles of the International Association of Insurance Supervisors
2. An analogue to R5 does not appear in the table above – to some extent this has been implemented already, but not in an entirely satisfactory manner
3. While R3 (put JBC & SBC on commercial basis) further moves to privatization (R10 & R16) are not mentioned
4. In relation to pension and social insurance, this was not a focus of the 2012 analysis, but will form a significant component of CMDP III

SI#	GoB Insurance Policy Objective	CMDP II, 2012 Insurance Sector Road Map	Short term		Mid-term		Long term 2018 2021
			2014	2015	2016	2017	
1	To make ongoing reform activities target oriented	R1 (more or less); R1 is achieved to some extent					
2	To ensure appropriate legislative structure a. Review of all insurance related laws; b. To enact all rules and regulations under the Insurance Act 2010 and the IDRA Act 2010; c. To make the Insurance Act and the Rules consistent with international standard.	R2					
3	To operate SBC and JBC on commercial basis To amend the Insurance Corporation Act 1973.	R3					
4	All companies meet revised minimum capital To identify the deficit in revised minimum capital requirement in different companies and take initiative to make that good.	R4					
5	Introduction of data and information exchange a. Development of standardized reporting template by the regulator for transparent maintenance of accounts and monitoring system, electronic data exchange and introduction of computerized risk based regulatory system; b. Introduction of appropriate software based online reporting system.	R7					
6	To enact investment rules and to remove irregularities from investment	Included in R1					
7	To review laws that are inconsistent with the Insurance Act	Included in R2					
8	Deposit insurance	Clarify meaning w/IDRA. If this is a “policyholder protection fund”, then included in R2					
9	Universal legal expansion of insurance	Clarify meaning w/IDRA					
10	Implementation of institutional risk management process	Not specifically mentioned					
11	Initiative for regulation of all micro-insurance service	Included in R11 & R13 to some extent					

Sl#	GoB Insurance Policy Objective	CMDP II, 2012 Insurance Sector Road Map	Short term		Mid-term		Long term
			2014	2015	2016	2017	2018 2021
12	Strengthening of IDRA: a. Meeting the human resource deficit; b. Ensuring physical infrastructure; c. Appropriate training for human resources; d. Ensuring operational independence; e. Arranging sufficient fund.	R6					
13	Uniform institutional structure for all insurer	Not advisable – follow up with IDRA on reasons they feel necessitates					
14	Bringing in professionalism in insurance industry	R12					
15	Human resource development in insurance industry a. To transform the Bangladesh Insurance Academy into a strong autonomous institute; b. To facilitate achievement of degrees in insurance profession including actuarial science jointly in collaboration with high standard local universities or foreign chartered insurance institute or universities; c. Incorporation of insurance and risk management as a subject in graduate and postgraduate courses in different universities; d. Making it mandatory to have degree or diploma in insurance and risk management to get an executive position in insurance industry.	R12					
16	Review of regulations on actuarial valuation of asset and liability	R8					
17	Institutionalization of customer complaints	Not specifically mentioned					
18	Universal internal inspection and audit	Not specifically mentioned					
19	Professionalism of regulatory body a. To ensure insurance knowledge and skill of IDRA Members and senior officials for the purpose of ensuring professionalism of the regulatory authority; b. Introduction of special allowance for having special professional qualification.	R6					
20	Public disclosure	R14					
21	Forming Financial Intelligence Cell	Not specifically mentioned					
22	Ensuring international standard of insurers' financial statements e.g. balance sheet, revenue account, profit-loss accounting etc.	R8					
23	Modernization of capital adequacy (implementation of Solvency -1); Revising capital adequacy policy to reflect Solvency 1 approach and introduction of risk based capital system.	R9					
24	Implementation of Solvency 2 - Determining solvency standard appropriate for local insurance industry by examining standards like Solvency 2	R15					
25	Determining Code of conduct and standard practices for insurance industry	Not specifically mentioned					
26	Prevention of irregularity with regard to commission and investment	Included in R2					
27	Review of life insurance premium; Enforcement of related clauses in the Insurance Act to review life insurance premium from time to time.	Included in R2					
28	Identifying reinsurer for availability of risk-based capital	Clarify meaning w/IDRA					
29	Promotion of export credit guarantee scheme	Not specifically mentioned					
30	To ensure Shariah-based disciplined management of Islami	Not specifically mentioned					

Sl#	GoB Insurance Policy Objective	CMDP II, 2012 Insurance Sector Road Map	Short term		Mid-term		Long term
			2014	2015	2016	2017	2018 2021
	insurance.						
31	To improve skills of Brokers/Financial Associates/Adjusters	Included in R12					
32	Expansion of local reinsurance market	related to R3					
33	Insurance of direct assets	Clarify meaning w/IDRA					
34	Increase public awareness about insurance: a. Increase public awareness about the benefit of insurance; b. To use mobile phone, internet and other social media in addition to conventional media like radio, television and print media; c. Undertaking promotional initiatives.	R14					
35	Promote insurance literacy	R14					
36	To make insurance mandatory for workers' compensation	Not specifically mentioned					
37	Introduction of pension and retirement benefits for financial security for private sector	Not specifically mentioned					
38	Diversification of insurance: a. Product diversification for all classes of people from developed to underprivileged section based on their profession or business; b. To identifying unpopular and antiquated life insurance product and get rid of them.	R13					
39	Institutionalization of group insurance in commercial institutions	R13					
40	Diversification of conventional insurance agency	R13					
41	Spreading insurance service outside the country	Clarify w/IDRA that this is referring to outward reinsurance.					
42	Introduction of rewards in insurance industry	Clarify meaning w/IDRA					
43	Emphasize on women in insurance sector	Not specifically mentioned					
44	National and regional cooperation in encountering large risks	Related to R3					
45	Development of new product in accordance with customer demand Establishing research cell in every insurance company.	R13					
46	Review of mortality and morbidity tables Usage of updated data for determining appropriate premium rate and designing product.	Included in R8					
47	Introduction of corporate governance in insurance industry	Not specifically mentioned					
48	Introduction of National Insurance Day	R14					
49	Encouraging development of welfare insurance for poor class a. Ensuring that private insurance companies extend their services to rural and underprivileged communities; b. Encouraging insurance companies by IDRA and government to develop insurance policies with premium that is appropriate for the financial capacity of poor and marginalized communities; c. Use of group micro-insurance within the scope of poverty reduction program	R13 and R11					
50	To introduce social insurance program at national level	Not specifically mentioned					

APPENDIX 5

PENSION AND PROVIDENT FUNDS

APPENDIX 5: Pension and Provident Funds

1	Background	1
2	Pension and Provident Funds in Bangladesh	2
2.1	Composition of Labor Force	3
2.2	The rising costs of an aging population	3
3	Current Arrangements for Old Age Income Provision	4
3.1	Legal and Regulatory Framework	4
3.2	Civil Service/Military Sector	5
3.3	The Formal Private Sector	6
3.4	The Informal Sector	7
3.5	The Old Age Allowance Scheme	7
3.6	Other ad-hoc Schemes	8
4	The Case for Reform	8
5	Relevance for capital markets	9
5.1	Prefunding	9
5.2	Regulation of Pension Investments	10
6	Next Steps	15
6.1	Analytical Framework	15
6.1.1	Evaluation Criteria.....	15
6.1.2	Stylized Approach.....	16
6.2	Situation in Bangladesh	17
6.3	Pension Policy/White Paper	17
6.4	Actuarial Assessment	19
6.5	Conclusion	Error! Bookmark not defined.

APPENDIX 5: Pension and Provident Funds

1 Background

In our Final Report for CMDP II, we reported in some detail on the state of pensions and provident funds in Bangladesh. With one notable exception, much of the information we reported in that report remains valid.

Limited Coverage – very few people in Bangladesh are covered under any type of old-age income security system/program. The largest pension scheme in existence is the civil service scheme (Government Employees Pension and Provident Fund Scheme – GEPPF). Government employees constitute approximately 2% of the labor force. The other major category is pension and gratuity funds provided by private sector firms/employers. These are loosely regulated under labor and tax laws providing for the structural, administrative and tax aspects of these schemes. While employers are required to establish such schemes if formally demanded by 75% of their employers, lack of enforcement renders this requirement ineffectual in terms of compelling employers to provide for the pension needs of their employees.

Limited Funding – The GEPPF is an unfunded (pay as you go – PAYGO) system. Contributions (from the employee) are only required for the Provident Fund component, but there is no accumulation of funds. These contributions are treated by the government as revenues, and benefits are paid through current-year budget allocations. The private sector pension and gratuity fund schemes are funded. Governance (including investment governance) of the schemes is controlled by provisions in the trust and labor laws.

Limited Awareness/Concern – We detected limited awareness of, and concern over the state of affairs with respect to pensions. The officials we met in 2012 had limited interest in whether or not the GEPPF was sufficiently meeting the needs of those covered in a sustainable manner. We were not made aware of any officially commissioned studies done in respect of pensions, and the few that had been done independently by various researchers had consistently pointed to the difficulty of obtaining reliable information on pensions in Bangladesh. The independent studies that addressed the matter had done so in a cursory and shallow manner – none of the studies were based on actuarial assessment of the government's unfunded/contingent liability, or the program's long range sustainability.

Previous attempts at engaging with the government on the matter of pension reform - by the ADB, World Bank and others - have been largely unproductive, reportedly due to a lack of “political will”. Various ADB reports indicate that previous work was undertaken under the auspices of ADB between 1993 and 2003, although there

appears to have been no follow-up since that time. A brief analysis of this work is found in Annex B.

While the above description continues to broadly apply, significant recent developments may portend an opportunity for the ADB to (re)engage with the government on the matter of pension reform.

In March, 2013 a consultant (Index Capital) engaged by the government delivered its Final Report on the matter of "Developing a Comprehensive Provident/Pension System in Bangladesh"¹. This report was commissioned by the public debt management department at Bangladesh Bank to "evaluate provident funds as a future source of demand for government securities"² While the motivation for commissioning the above mentioned study may be somewhat inconsistent with what are generally considered - by ADB and the donor community - to be the primary objectives of a sustainable pension reform program, we believe this development may, nonetheless, be an indication of an emerging "political will" to undertake comprehensive pension reforms.

We were also informed that an initiative was started earlier (in 2014) by inviting a person from the Indian pension regulatory agency to begin studying the situation in Bangladesh, but this consultant is reported to have left abruptly and no further work was done on this issue. The circumstances of this attempt at addressing the pension issue are unclear. Nonetheless, this might indicate an interest in pursuing the pension portfolio which seems to have been lacking previously, so we take this a positive sign and an indication that further studies are likely to be better received than in the past.

There is also a Draft National Social Security Strategy, whose latest draft (4th draft) is dated June 2014. This covers a broad range of social security issues, not just pensions. Comments on the pension component of this draft strategy can be found below.

This Appendix will first review what is known about pensions in Bangladesh (information gained from our work in 2011/12 and subsequent investigations conducted in 2014), and then provide some suggestions on ways ADB might (re)engage with the GoB on the matter of pension reform more generally and more specifically on the question of how pension reform can support the government's objectives for capital market development.

2 Pension and Provident Funds in Bangladesh

As mentioned above, pension and provident funds are only narrowly available in Bangladesh and play a limited role in the development of its capital markets. To better

¹ Terms of reference as included in "Final Report - The Development of Comprehensive and Sustainable Pension System in Bangladesh", Index Capital Group, March 10, 2013.

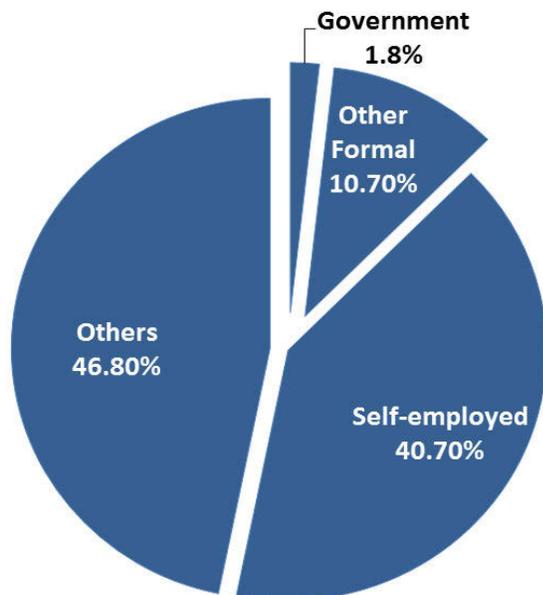
² *Ibid*

understand the environment for pensions in Bangladesh and the potential role pensions can play in the development of capital markets, it may be useful to look at a number of factors from a macro perspective.

2.1 Composition of Labor Force

The first is the broad composition of Bangladesh's work force. The distribution of the

Figure 1 – Composition of labor force



Source: Labor Force Survey 2010

work force among the various sectors (as reported in the 2010 Labor Force Survey) is shown in Figure 1 below. The survey indicates that **87.5% of the labor force is in the informal sector** (this includes the self-employed and others outside formal contractual employment), and only less than 2% is in the government sector.

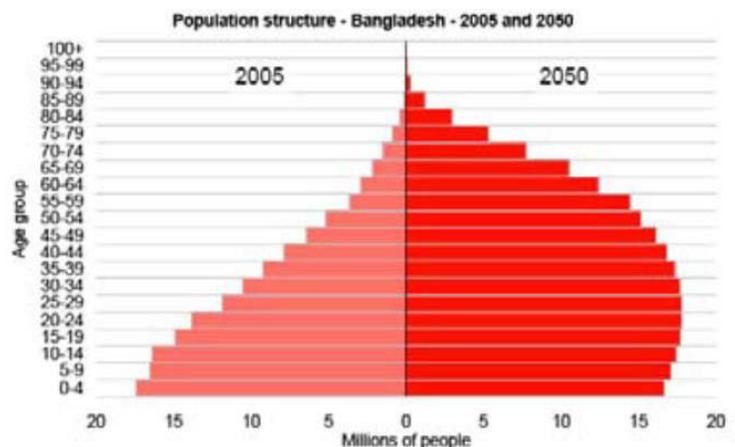
The informal sector poses significant challenges for pension reform from the perspective of coverage. The difficulty and potentially high cost of extending coverage to this segment of the work force make its inclusion in a comprehensive pension reform a costly affair, yet given the exceptionally high proportion of the labor force this segment comprises, any pension

reform agenda that excludes it would most likely fail to meet the “equity” objective, one of the key objectives of pension reform, and, as a practical matter may be difficult to implement from a political economy perspective.

2.2 The rising costs of an aging population

Given that the predominant scheme in Bangladesh is the one covering government workers (civil and military), and that this scheme is unfunded and financed through the fiscal budget (i.e. pay-as-you-go PAYGO), examining the fiscal cost of this program (and the trend in this cost) could provide valuable insights into the long range sustainability of this scheme – although an actuarial valuation would provide a more

Figure 2 - Bangladesh's aging population



comprehensive and definitive picture of sustainability. The analysis of the pension system undertaken under TA-BAN-2915 (which is summarized in the Annex) indicates that an actuarial valuation of government pension schemes was performed during this TA, but we have not seen it. Given that it is probably 15 or more years old its usefulness would be very limited. Some very rough estimates were provided in the Pension Fund report prepared by the Index Capital Group for the Bangladesh Bank, but this report recommended a proper valuation be performed. The valuation should also include cash flow projections to indicate expected future expenditures under a pay-as-you-go system. It is likely that such payments will increase at a faster pace than GDP growth. This would appear to be consistent with the underlying demographic trends in Bangladesh.

As shown in the graphic to the right, while currently young, the population of Bangladesh is expected to age at a rapid pace in the next 3-4 decades. The proportion of the population in the 60+ age group is expected to increase to 17 percent by 2050 (from 6 percent in 2006). The resulting fiscal pressures this aging is likely to produce may provide one of the compelling reasons for the GoB to be concerned about old-age income provision/security, and for it to muster the "political will" needed for comprehensive pension reforms. While the draft social security strategy is a good start, the fact that it recommends that government pensions be left untouched and without actuarial analysis is an indicator that this will is largely absent. This will need to change.

3 Current Arrangements for Old Age Income Provision

The current systems in place for providing post retirement income to workers from the different sectors are reviewed below.

3.1 Legal and Regulatory Framework

In Bangladesh, there is no central law addressing the matter of pensions, rather pensions (to the extent they exist) are governed by a patchwork of laws and regulations as summarized in Table 1 below.

Table 1 – Legal/Regulatory Framework for Pensions

	Acts & Rules	Comment
Private Sector	Pensions Act, 1871	Limited relevance to current public system
	Provident Funds Act, 1925	Limited relevance to current PF system
	Labor Law, 2006 Amendment (proposed)	Central law for private sector PF for factories and industries employing labor
Government Sector	Trust Act, 1882	Governs contracts for beneficiaries' assets
	Mutual Fund Rules, 2001	2011 Circular: PF trust can be a sponsor of Mutual Fund
	Public Servants (Retirement) Act, 1974 (Amend); Rules, 1975	Governs pension provision for all government employees, including self-regulatory, local, and SOEs
	GPF & CP Rules, 1979;	Provident Fund options and procedures
	Treasury Rules for Pension	Appropriation and funding process
	Rules & Procedures of Pension Simplification, MoF, 2009	Detailed instructions and forms for pensioners

Source: Index Capital Group, *Development of Comprehensive & Sustainable Pension System in Bangladesh*, 10 March 2013

3.2 Civil Service/Military Sector

The following schemes are pertinent with respect to **civil/military government workers**:

Pension-cum-Gratuity Scheme: this is a defined benefit (DB) scheme providing monthly income after retirement and is financed by government revenues (i.e. from annual budget allocations). The scheme is "unfunded" and financed on a Pay-As-You-Go (PAYGO) basis; that is to say that the annual benefit payments are met through current fiscal year budget allocations and no separate reserves are set aside to meet any portion of future benefit payments. The retirement age is presently set at 59 years, and the present "replacement rate" is established at a total (between the two components) level of 80% of the employee's final monthly pay, half of which can be taken as a lump-sum distribution (gratuity portion), with the other half used to determine a monthly payment that continues until death, provided the employee has 25 years' service at the date of retirement; reduced factors apply where service is shorter. There is apparently an option to take the entire entitlement as a pension, but we understand that the existence of this option is not well-known and seldom exercised. The formulas for computing the benefit level for the gratuity and pension benefits are determined from time to time by a government "Pay Commission" which is appointed on an ad-hoc basis³ to consider matters of pay and benefits for government employees. The latest Pay Commission was appointed in December 2013, and is expected to deliver its report and recommendations to the government by December 2014.

A simple method is used to compute benefits due on retirement. The pension (recurring monthly until death) benefit is calculated at 230 times 40% of final monthly pay, with the other half being paid as a monthly pension. There is also an option to take the entire entitlement as a lump sum, with the second half of the entitlement being commuted at

³ We are informed that eight such Pay Commissions have been constituted since Independence.

a factor of 115. No rationale was offered for these two different factors (the first appearing to be over-generous, while the second under-generous).

While this appears to be relatively generous (international best practice generally suggests a replacement ratio of 70% taking into account all universal benefits available) a more in-depth study would be needed to corroborate this judgment. As noted in the appendix a proper balance would need to be struck between adequacy and affordability, which would necessitate a proper actuarial evaluation of the pension plan for various types of employees. More material on pension policy is found below.

General Provident Fund: this is a defined contribution (DC) scheme providing a lump-sum amount and requires employee-only contributions. It is unfunded, with the government treating contributions as part of its revenues and benefit payments a part of its expenditures. The profit (or interest) credited each year on the balance in employee accounts is declared on a notional basis since there are no assets backing the liabilities on which actual returns can be determined. The amount credited to an employee can be withdrawn at his/her discretion for specified reasons (on a refundable and non-refundable basis) implying that, at retirement, there may or may not be an amount available for pension purposes. This scheme is available in addition to the Pension-cum-Gratuity scheme.

Contributory Provident Fund: this scheme is provided to those not covered by the Pension-cum-Gratuity scheme. It is a defined contribution scheme financed by employee contributions which are matched by government. The other characteristics are similar to those of the General Provident Fund scheme.

To fully understand government workers' post-employment benefits it is important to be aware of additional schemes that may provide benefits on retirement and are financed by employee contribution (these include Benevolent Fund and Group Insurance schemes).

Employees of state owned enterprises (SOEs) have similar combinations of schemes although the details can vary from entity to entity.

3.3 The Formal Private Sector

With respect to workers in the **formal private sector** there are two primary regulatory requirements that can impact old-age income provisioning:

Labor Law Gratuity: this is a mandated defined benefit amount (calculated as 30 days wages for each completed year of service) to be paid on termination of employment. The benefit is to be financed by the employer but no prefunding is required until the employee leaves the service of his/her employer.

Provident Fund: employers may provide this benefit but it is generally only *mandatory* if 75% (or more) of an employer's workers demand such a scheme in writing. It is mandated for some industries (e.g. tea plantation and newspaper workers) for which contribution rates are specified in the range of 7%-8%. There appear to be no requirements as to when and how employees may access their accumulated amounts in such schemes.⁴

3.4 The Informal Sector

With respect to **informal private workers** there are no specific arrangements for old-age income provisioning either on mandatory or voluntary basis. However, there is a national Old-Age Allowance Scheme (OAAS) that provides a monthly benefit of BDT 300 (approximately USD 4) on a means tested basis to males aged 65 and above and also females aged 62 and above. The scheme is financed by the government and funded on a Pay-as-You-Go basis. The monthly benefit represents approximately 6% of the national average income or 26% of the international poverty line.⁵

In addition to the above mentioned support systems, workers from all sectors can, of course, have individual savings/assets that could provide old-age income or receive support from family members.

As mentioned above, 87.5% of the labor force is in the informal sector. This includes the approximately 10% of urban employment that is estimated to be informal, and the 36 million workers engaged in agriculture. The bulk of old-age income support for this large segment of the population is informal and provided by their families and other informal support mechanisms.

3.5 The Old Age Allowance Scheme

Until the late 1990s, the only real pension scheme in Bangladesh was the public sector workers' scheme that had been established in 1974. In 1997-98, the government introduced the Old-Age Allowance Scheme (OAAS) in all rural areas of Bangladesh as well as in municipal areas. This was intended to provide old age income support for the ten poorest elderly men and women in each ward. OAAS covers the elderly poor - men over the age of 65 and women over the age of 62 with average annual income not exceeding BDT 3,000. Only one member from each family is eligible for the OAAS benefit. Payment is made quarterly and administered through local branches of government-owned banks.

⁴ For example, we are informed that a monthly "medical allowance" of BDT 700 (for those under 60) and DBT 1,000 (for those over 60) is also applicable.

⁵ Source: www.pension-watch.net

An elaborate system of committees and sub-committees, extending from national to ward level, is responsible for identifying eligible persons according to well-defined criteria of age, economic condition and health status. Evaluations indicate that the program has been successful in reaching the elderly poor in rural areas but that it covers only a fraction of the eligible.⁶

OAAS is financed from government revenues and is administered by the Ministry of Social Welfare. In 2007 the benefit was extended to cover city-dwellers. Between 1998 and 2012 the number of beneficiaries increased more than six-fold, the monthly benefit three-fold, the budget allocation more than 18-fold, and its share of gross domestic product (GDP) increased from 0.02 per cent to 0.13 per cent. The monthly benefit is currently BDT 300 (less than USD 4). There are approximately 2.5 million approved beneficiaries, and the annual budget allocation is BDT 8.9 billion.

3.6 Other ad-hoc Schemes

It has been reported that a range of ad hoc schemes providing differing levels of old age income support are available through various (mainly financial) institutions. An example of such a scheme is the Grameen Bank pension scheme. Grameen is a microfinance institution (MFI) providing a range of financial products and services across the country, mainly in rural communities. In response to its borrowers' concerns over the lack of a reliable source of income in retirement, Grameen Bank developed and has been offering an old age pension scheme which reportedly has become very popular. Under this program, all borrowers with a loan above a certain threshold (i.e. BDT 8,000 or USD 103) are required to save a small amount (i.e. BDT 50) each month over a period of 10 years. At the end of the period, the depositor receives the amount of the money contributed plus compounded interest.

This portable defined contribution scheme covers those just above the cut-off for the OAAS and may be a useful model to (at least partially) fulfil the need for old-age income insurance - at little or no direct cost to the government.

4 The Case for Reform

Even this cursory review of the environment clearly shows that, as presently structured, the scope for pension schemes to play a meaningful role in the development of the capital markets is limited at best, as coverage is limited, and almost the entire spectrum of what is available is financed on a Pay-as-You-Go basis.

⁶ Paul-Mazumdar and Begum, 2001

However, the review also clearly shows the need for developing a comprehensive pension policy and implementation framework to protect the elderly against financial insecurity. This stems from the following observations on the current situation:

- There are significant gaps in coverage under the current framework not only for the informal private sector, but also for the formal private sector;
- The formal private sector is inadequately protected through existing labor law gratuity and provident fund provisions;
- The adequacy, equity and sustainability of government and SOE schemes have not been assessed;
- There is an over-reliance on lump sum schemes and insufficient provision of monthly income under the private sector schemes. It is also unclear whether these schemes are intended to provide income protection during unemployment or on retirement or both: potentially resulting in neither objective being effectively achieved.
- There is a lack of protection for private sector and SOE workers' pension assets since they are not required to be segregated from employers' assets, have no minimum funding requirements and are not accounted for in line with current international accounting standards.

5 Relevance for capital markets

While the primary policy objectives (and appropriate evaluation criteria) for pension systems are those concerned with achieving adequacy, equity and sustainability, an important secondary policy objective/evaluation criteria are the contributions pensions can make to increasing savings and to the development of the financial sector and capital markets more specifically.

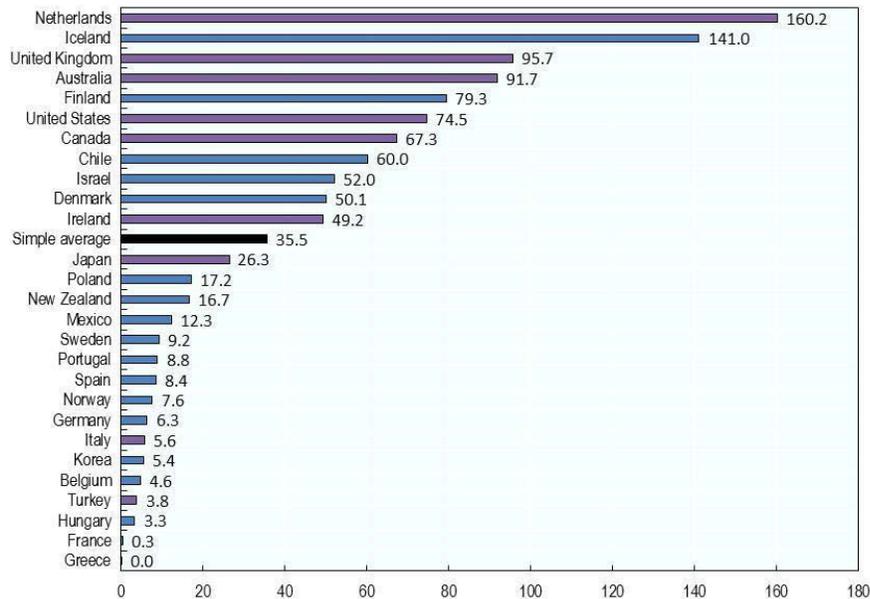
5.1 Prefunding

Experience from other countries, as indicated by **Figure 2**, which reflects public and private pension fund assets in relation to the national GDP for selected OECD countries, suggests the potential role that pension investments can play in the development of capital markets.

The countries with the highest pension assets-to-GDP ratios are typically ones that have "prefunding" requirements for one or more elements of their pension schemes. The decision to prefund, however, requires careful consideration of benefits and costs, as

advantages of pre-funding versus pay-as-you-go cannot be taken for granted.⁷ This decision also requires a close look at the implementation capacity of a country.

Figure 2 - Pension Fund Assets Relative to National GDP



Source: OECD's Pension Markets in Focus 2013 (data relates to year 2012)

5.2 Regulation of Pension Investments

If some part of the public and/or private pension system is to be funded then it will be necessary to determine which approach to take with respect to regulation of pension investments. The OECD 2011 survey of investment regulation reveals two broad approaches: one being that of unrestricted allocation of investments across different asset classes and the second being that of controlled allocation of investments.

The unrestricted approach to the allocation of investments across asset classes is followed by more than a third of OECD countries, including Australia, Belgium, Canada, Germany, Ireland, Japan, Netherlands, UK, and USA. These countries do, however, still have some stipulations such as disallowing specific asset types or foreign investments; requiring diversification; avoidance of conflict of interests; or disallowing personal loans.

The supervisory processes of these countries rely on "Prudent Person Rule". They require robust governance systems and practices; written investment policies that identify all potential risks and their mitigation strategies; separation of critical functions including that of custodian and auditor. These countries have well established regulatory environments and standards of practice for all key players, including pension fund

⁷ For example, political manipulation can make the benefits of prefunding illusive. Furthermore if GDP growth rate increases exceed the rate of growth of assets in pension funds PAYG is in fact a lower cost option in the long run

trustees, banks, asset managers, investment advisors, corporates, auditors, actuaries, etc.

The remaining two-thirds of the OECD countries follow some variation of controlled allocation of investments across asset classes. They stipulate some level of minimum or maximum asset allocation by class of asset, type of pension fund, and/or investment fund. Although there are controls on allocations, they may still allow 100% investment in equities for some pension or investment fund types.

The objective of the controls is to monitor and control riskier investment policies & strategies, and/or to reduce the number of investment fund options, to make the selection among them a simpler matter. This regulatory approach recognizes that not all key players are mature or adequately regulated.

For this approach to be effective a capable regulator is required that can issue, monitor, and enforce compliance with the guidelines, without which investment regulations in and of themselves can achieve very little. In adopting this approach some key questions to keep in mind are: what is the capacity of the investment management industry to provide high quality investment outcomes in the long run; what is the capacity of the regulator to provide meaningful and objective regulatory oversight to this key function?

5.3 Lessons From Other Countries

A question often asked, is: "Can we learn from successful implementation of provident funds or defined contribution systems in other countries?"

While this is a good question, applying lessons learned in other countries is often not as straightforward or easy as it seems, for the following reasons:

- Pension reform needs to be performed within the framework of an overall pension policy, countries differ in their economic and social systems, so what might be successful in one context might not be as successful elsewhere
- In some cases it might be "too soon to tell"⁸ – often the introduction of a defined contribution system is received enthusiastically during the accumulation phase, less so when disappointing pensions result some years (perhaps as much as 20 to 25) later
- Sad to say, we seem to have more problematic scenarios to draw from than successful ones, although valuable lessons can be learned about what not to do

⁸ Attributed to Chou En Lai when asked if the French Revolution was successful

- Whole books have been written on this subject⁹, which contain more detail than can be condensed into this report

Nonetheless, one widely cited example of a successful introduction of a provident fund is clearly Singapore's Central Provident Fund¹⁰. Similarly the Malaysian system, the Employees Provident Fund¹¹ could also be considered reasonably successful. While few would consider Singapore to currently be "emerging" (it has truly emerged), or even to some extent Malaysia, their provident funds were implemented at a time when their economies would have been considered to be "emerging economies". Some of the key lessons learned would include:

- First formalize the workforce – if a large part of the workforce remains in the informal sector then imposing significant contribution rates on the formal sector will drive employers out and even those who remain will take avoidance actions, such as reporting the minimum wage and paying the rest in cash
- We seldom if ever start with a "clean sheet of paper" – there are often pre-existing systems which are in various degrees of stress and we need to continue paying pensioners and recognizing past liabilities for those already in the workforce, so this often constrains our actions
- Reforms often get stuck in the transition phase or are even reversed or abandoned, often due to changes of government or other political exigencies, even among reforms which might eventually have been successful
- Ensure there are adequate investment opportunities, including foreign investment, so that there is an expectation that a positive real rate of return can be earned over the long run, otherwise the program will destroy value
- Ensure that the administrative machinery is up and running before the introduction of the program ("introduce in haste, repent at leisure")
- Ensure there is efficient and transparent operation and that costs are kept down, again so that value is created rather than destroyed

Curiously enough, the same lessons are learned from the introduction of systems which have become problematic, some of which this consultant has had personal experience with. There are other lessons to be learned even from systems such as Singapore's and Malaysia's which can be considered reasonably successful, where for example, there are concerns about the transparency of the investment process and the fact that the pension fund has excessive influence, given its size. There is also concern that the

⁹ See for example *Old Age Income Support in the 21st Century* by Holzmann and Hinz, which has been cited elsewhere in this report, as well as *Complementary and Private Pensions throughout the World 2008*, jointly published by OECD, ISSA and IOPS

¹⁰ [CPF Board - About Us - my CPF 1](#)

¹¹ [KWSP - Home - KWSP](#)

investments are not real savings – in some cases much of the so-called investment is recycled into housing and housing loans, which does not necessarily give rise to economic growth and can distort the market for savings and borrowing.

Another example of a reasonably successful system would be Botswana. Here the previous pay-as-you-go defined benefit scheme for public officers was replaced by a generous defined benefit scheme about 10 years ago. While this is very popular with members, some issues remain:

- It does not cover the whole workforce, or even the whole formal sector, it is for public officers only
- Sufficient due diligence in regard to the initial credits for past service was not performed, this was mostly performed at retirement, at which time mistakes (some of an enormous magnitude) were discovered – the regulatory authority spends most of its time dealing with “complaints” related to this issue
- Seventy percent of the assets can be invested abroad – this is very encouraging, but is scheduled to be reduced, which could put a strain on the small capital market
- The fund has a dominant position in the capital market, which causes concern
- Regulation by the Non-Bank Financial Regulatory Agency (NBFIRA) is problematic, NBFIRA’s toolkit and knowledge are not up to the job of regulating this behemoth (in terms of the size of Botswana’s markets and population)

By looking at Bangladesh and focusing on some of the less than successful transitions, we can go through some of the lessons with more detail, namely:

- Degree of formalization of the workforce – it is unlikely that Bangladesh will reach the degree of formalization of Singapore or even Malaysia anytime soon; alternative strategies that do not rely on a high degree of formalization should be considered, perhaps using industry groups and some form of “universal pension” to assist the elderly who have never been in the formal sector, as discussed in greater detail in the pension policy we have drafted (and seems to be in line with government thinking)
- Ensure that any existing pension programs, often pay-as-you-go social security or government employee programs, are sustainable and on sound actuarial footing; if this is not the case this will undermine the introduction of a provident or defined contribution fund, as subsequent reforms (often in a panic) will undermine creditability of the pension system as a whole

- Ensure that any transitional arrangements are well-thought out and generally acceptable. This might not apply to Bangladesh, unless reforms of the public sector pensions are brought in (this is not part of government policy currently, but there are no recent actuarial studies of the government employees' pensions and the suspicion is that they are not sustainable)
- The close-held nature of many investments and the less than market returns on government bonds in Bangladesh make this a challenge. It is likely there will be resistance to foreign investments for pension funds. Reforms in the government bond market and greater openness and transparency of equity markets will help in this regard, but this will take time. Pension funds in Tanzania, Bhutan and other countries in which this consultant has worked have destroyed over 90% of investment value over the career of the typical worker through lack of ability to consistently earn a real rate of return (i.e., the investments in a well-diversified fund typical in developed countries would probably have yielded 10 times or more of final salary, whereas actual returns were less than a year's salary, destroying over 90% of the potential value)
- Administrative expenses often take a significant proportion of the contribution, much more than is typical in defined contribution and similar schemes in developed countries; this depresses the net rate of return very considerably – in Rwanda expenses exceeded investment income, contributors would have been better off stuffing Rwandan francs under their mattresses. We need to make use of modern electronic platforms to decrease expenses and to increase transparency and efficiency
- There should be as much competition as possible – large government run programs such as Singapore's and Malaysia's can become monopolistic and non-transparent. Malaysia has allowed competition to KWSP, but the private funds are apparently not very successful. While allowing private competing funds would seem to be the best option, problems abound too. In particular the infrastructure should be in place before the system is launched – examples of where this was not done is Kazakhstan, which introduced a Chilean style system to replace its Soviet-era defined benefit pay-as-you-go system about 15 years ago, with about 10 competing funds, plus the state run “default fund”, the GNPF, for those who did not chose a fund; 10 years later (perhaps even today) millions of accounts were still orphans with little hope of resolution. Five years ago Ghana introduced a mandatory defined contribution system to replace the 25% cash-out from the partially funded defined benefit scheme (which continues in existence at about 75% of previous contributions and benefits); trustees and other service suppliers were not registered until 2 years after inception and we are only just resolving huge balances at the Bank of Ghana, with numerous problems still to be resolved

- Ensure the regulatory system and regulatory agency are up to the job – this requires a system of risk based supervision, probably using modern RBS software, otherwise the regulator will be overwhelmed and the potential for disasters (fraud, misappropriation, Ponzi schemes and the like) could cause confidence in the system to collapse

6 Next Steps

In this section, we provide our thoughts/views on the steps that would be required to initiate pension reform in Bangladesh. First we provide some thoughts on an appropriate analytical framework that can be used to assess pensions in Bangladesh. Then we suggest a potential path to pension reform in Bangladesh. ADB may wish to consider supporting one or more of the steps along this path to pension reform. A first, and crucial, step in this plan is the development and adoption by the government of a National Pension Policy. We have attached, as Annex A to this note, an annotated outline for such a policy paper on pension reform.

6.1 Analytical Framework

The objective of a pension system is to provide retirement security for the population. It can encompass a poverty reduction program for the general population as well as poverty avoidance for those in the workforce and who were not poor during their working lives and so should not be poor during their retirement.¹²

The work done in pension reform by the World Bank, ADB and other donors over the last two decades provides a useful analytical framework for assessing pensions and old age income support mechanisms.

6.1.1 Evaluation Criteria

This experience suggests that pension systems should be assessed as to the degree to which they meet the following criteria¹³:

Adequacy - An adequate system is one that provides benefits to the full breadth of the population that are sufficient to prevent old age poverty on a country-specific absolute level in addition to provide a reliable means to smooth lifetime consumption for the vast majority of the population.

Affordability - An affordable system is one that is within the financing capacity of individuals and the society and does not unduly displace other social or economic imperatives or have untenable fiscal consequences.

¹² Economists refer to this as “consumption smoothing”

¹³ See Old Age Income Support in the 21st Century, Robert Holzmann and Richard Hinz, The World Bank, 2005

Sustainability - A sustainable system is one that is financially sound and can be maintained over a foreseeable horizon under a broad set of reasonable assumptions.

Robustness - A robust system is one that has the capacity to withstand major shocks, including those coming from economic, demographic and political volatility.

6.1.2 Stylized Approach

Another useful analytical tool is provided by the World Bank classification of the types of pension provision into five pillars.¹⁴ The following table illustrates this classification scheme:¹⁵

Table 2 – World Bank Classification of Pension Systems

Pillar	Target group			Main criteria		
	Lifetime poor	Informal sector	Formal sector	Characteristics	Participation	Funding or collateral
0	X	X	X	“Basic” or “social pension”, at least social assistance (universal or means tested)	Universal or means tested	Budget or general revenue
1			X	Public pension plan, publicly managed (defined benefit or notional defined contribution)	Mandated	Contributions, perhaps with some financial reserves
2			X	Occupational or personal pension plans (fully funded defined benefit or fully funded defined contribution)	Mandated	Financial assets
3	X	X	X	Occupational or personal pension plans (partially or fully funded defined benefit or fully funded defined contribution)	Voluntary	Financial assets
4	X	X	X	Access to informal support (family), other formal social programs (health care), and other individual financial and nonfinancial assets (home ownership)	Voluntary	Financial and nonfinancial assets

When examining pension reform options, it is usually useful to express these options in terms of one of the above pillars and rank each option in accordance with the evaluation mentioned in the prior section.

¹⁴ It should be emphasized that the World Bank is not recommending that all countries implement all five pillars, but the “pillared approach” presents us with a useful framework for analysis.

¹⁵ Ibid

6.2 Situation in Bangladesh

Currently in Bangladesh only elements of pillars 0, 3 and 4 exist. Pillar 4 relates to informal transfers and is added for completeness and entails little or no government involvement. As far as Pillar 3 is concerned, this currently relates mostly to government employee pension plans. There are probably some pensions in the private sector, but there is no regulation, and data are sketchy. The OAAS, while not a universal program, does cover the most vulnerable segment of the population.

6.3 Pension Policy/White Paper

A first, and crucial, step is the development and adoption by the government of a National Pension Policy. As mentioned above, we have attached, as Annex A to this note, an annotated outline for such a policy paper on pension reform. As we have noted, a Draft National Social Security Strategy is in its fourth draft. It covers the pension sector to some extent, but does not really provide adequate guidance for the way forward. In particular, as noted already, it proposes that no change be made to government pensions, nor that any evaluation of the financial impact of any proposals be undertaken. A brief analysis of the pension component of this strategy is found below.

6.3.1 Analysis of Pension Component of Draft National Social Security Strategy

We have been provided with a copy of the National Social Security Strategy, 4th Draft, June 4, 2014. This is a very impressive document, running to 163 pages, the Executive Summary alone runs to 13 pages. It encompasses all forms of social security, including children, vulnerable women and so on. The comments below relate only to the pension components of this strategy and are taken from page xvii of the Executive Summary.

It should be noted that there seem to be inconsistencies between the Executive Summary and the body of the report. In particular, in the body of the report, at page 72, there seems to be a proposal that the National Social Insurance Scheme (NSIS), funded by employer and employee contributions, would in fact be a national body, regulated by IDRA, whereas the Executive Summary implies that each employer is obliged to set up a scheme. Page 72 does not mention non-pension benefits, whereas the Executive Summary does. Also, there is no mention of the possibility of establishing a Pension Regulatory Authority (PRA) to regulate private voluntary pensions in the Executive Summary, whereas it is mentioned on page 72; it might be logical to house regulation of the NSIS in the PRA, rather than IDRA. In fact some thought would need to be given to combining these two agencies, to achieve economies of scale.

Comprehensive Pension System for Elderly:

Initiative	Funding source	Comments
The Citizen's Pension for citizens who are aged 60 years and above and belong to the poor and vulnerable population	Budget	This is a good initiative and should be pursued. It should be costed on an actuarial basis to make sure that demographic changes do not make the costs increase beyond a tolerable level. Some mechanism should be included to adjust the age of entitlement as life expectancy increases In general it is recommended that this benefit be as universal as possible, to avoid complications of means testing. It should be taxable (which would affect a very small number of beneficiaries) and could also be "super-taxed" to recover it from the very wealthy elderly (for example in Canada it is subject to an extra 15% tax rate for recipients with incomes of about 1.5 times the average income)
Continue with the Government Service Pension with no change at this time.	Budget	Experience has shown that this approach can build up unaffordable off-balance sheet liabilities for the government and payments to former public servants can balloon and crowd out other social spending. It is recommended that an actuarial assessment be undertaken of this program to ensure sustainability, adequacy, affordability and robustness. This might not necessarily result in any changes to this program, but at least the GoB will be in a position to understand the costs and risks of this program
Introduce legislation to establish a National Social Insurance Scheme (NSIS), to be managed under the Insurance Development & Regulatory Authority (IDRA), which makes it obligatory for all private enterprises in the formal sector to offer a contributory pensions programme for all employees. The NSIS will provide pensions as well as address other contingencies (such as disability, sickness, unemployment and maternity).	Employer and employee contributions	While in principle admirable, this raises a number of fundamental issues. In general, countries which have introduced some form of mandatory pension are ones with formalized labour forces, where the informal sector does not really exist and opportunities to escape the tax net are extremely limited. In countries, such as Bangladesh, with a large informal sector and weak enforcement mechanisms such an imposition on employers is likely to increase rather than decrease the pressure to be in the informal sector. A better strategy could be to use sector organizations (e.g. garment workers, rickshaw drivers) to promote benefits and in fact this appears to be happening already. While providing retirement savings through a defined contribution pension plan is not excessively challenging, providing insurance type benefits is costly and risky and should not generally be provided by pension funds. We would need to work with the insurance industry to help to develop suitable products which would be profitable for the insurance companies and affordably priced for companies in the private sector
Review options to facilitate the development of Private Voluntary Pension (PVP), which are open to all citizens irrespective of occupation or formality of employment.	Employer and employee contributions	There are no barriers to do this on a voluntary basis right now, but the take-up seems very limited. If there is an implication that there be some form of tax-assistance to encourage this, then GoB would need to evaluate the effectiveness and efficiency of such a program. If it by and large simply reduces after tax costs to those who would take advantage of it anyway then this approach should not be pursued. If on the other hand there is evidence that this would increase voluntary savings and improve outcomes then a tax-assistance program could be introduced.

6.3.2 Towards a Sounder Approach to Pension Policy

To initiate this process, it will be important to identify the government officials that have an interest in pensions and make an assessment of their collective level of commitment to pension reform. It is likely that intensive work will need to be done in this regard. The political economy of pension reform is probably one of the most challenging aspects of pension reform and getting the right level of support from key political actors early in the process is a key determinant of success. There are many examples around the globe of unfinished reforms in the pension arena. One of the common factors shared by many of these stalled reform efforts is the lack of "political will." Many stakeholders have an interest in pensions and these interests must be balanced against the broader interests of society as a whole. Balancing these interests can often be a difficult task.

Difficult as it may be, this balancing of interests and building of consensus is well worth the effort. Through our involvement with pension reform initiatives across a broad range of developing countries we have observed that the most successful reforms initiatives are ones that have managed to develop broad-based consensus early in the process. This consensus is usually developed around a proposed policy coherently articulated in a draft policy paper on the subject. The policies set forth in this draft policy paper should be able to garner the support of a majority of the key/critical stakeholders (i.e. MoF (in both the capacity of public debt manager and key/chief financial sector policy maker), the key financial sector regulatory authorities (namely BB, BSEC, and IDRA) NBR, Ministry of Labor, Ministry of Commerce, Ministry of Social Welfare, representatives from the private sector and trade and industry associations.

A typical approach to developing pension policy is to evaluate the applicability, suitability, advantages and drawbacks of each of the five pillars¹⁶ in the World Bank classification of old age income support mechanisms. Any considerations to adopt/ implement a program would need to be assessed on the basis of an actuarial analysis of its costs to ensure they meet the evaluation criteria mentioned above, namely: adequacy, affordability, sustainability, and robustness.

6.4 Actuarial Assessment

A second, and related, step is to conduct a thorough review and actuarial assessment of the existing government pension schemes. These appear to be unfunded and without proper actuarial evaluation, although as noted previously an evaluation seems to have been performed under a previous ADB TA, but given that it is probably 15 or more years old, its usefulness would be very limited. This issue is discussed (admittedly from the perspective of government bond investment rather than from a pension policy

¹⁶ In reality just the first four pillars, the fourth pillar is really added for completeness and implies little or no government involvement

perspective) in the recent Index Capital report referenced earlier. This report makes a very crude estimate of the government's liability at BDT 65,000 crore, rising to BDT 78,000 crore by 2017. There is no estimate of the "current service cost", namely the cost of one year's accrual of benefits.

Once pension policy has been developed, and the appropriate data regarding government and non-government pensions has been collected, an assessment can be made of the liability for government pensions, the current service cost and the proposed reforms needed to ensure that government pensions meet the criteria above. The next critical decision will then be how to bring non-government workers into the pension system and what regulatory framework is required.

6.5 Concluding Remarks

One area that appeared initially to offer some promise for the prospects of pension funds in Bangladesh was a reported initiative by Bangladesh Bank to consider requiring all scheduled banks to offer pension plans to their employees in accordance with BB guidelines. However, upon pursuing this further, we were informed by BB and the MoF that this initiative was limited to the harmonization of pension plans already being offered by the government-owned banks.

As noted above, two of the important next steps for pensions in Bangladesh are:

- The development and adoption, by the government, of a pension reform policy that includes an approach to ensure that government pensions are adequate, affordable and sustainable and
- To perform actuarial evaluation of government pensions.

We would suggest that the ADB consider supporting one or both of these initiatives, depending on the government's level of commitment to pension reform.

Annex A - An annotated outline for a Draft White Paper on Pensions

The process of consensus can start with drafting a White Paper on Pension Reform. This could serve as the basis for the government's adoption of a National Pension Policy.

We would, therefore suggest ADB consider the development of a White/Policy Paper on Pension Reform as an initiative that could be supported through the "Piggy-Back" technical assistance being considered for CMDP III, and also consider the adoption by the government of a National Pension Policy as a Second Tranche Policy Action under the CMDP III Policy Loan.

The annotated outline below provides a summary of our initial thinking on the components of such a White Paper. It should be noted that the effort to produce a White Paper will require an actuarial assessment be made of the government's pension schemes, and thus, an allocation for actuarial input would be required.

Section 1 – Brief history of pensions in Bangladesh

This section should outline the historical development of benefits from the colonial era to the present time. This section should include data on population, contributors and pensioners during the relevant periods and notes on data gathering difficulties.

Section 2 – Brief description of pension system and other benefits

This section should detail the benefits payable to civil servants and others entitled to pensions. Summary tables of various categories of plan members should be included if this information is available. The Appendix should detail the source of information and provide more detailed breakdowns if relevant. Tables indicating detailed breakdown of expenditures on various benefits should also be included if this information is available.

Tables indicating the total workforce and a breakdown of membership and other relevant details (in a summary form in this section with more detail, if available, in an Appendix) should be shown.

Section 3 – Vision for future of pension system

This Section should discuss the main features of an effective pension system, namely: Sustainability; Adequacy; Affordability; Equity; Robustness.

The White Paper would need to review the components of the World Bank categorization of zeroth to fourth pillars and comment on current provisions and desirability of changes to current pension provisions and implementation of components which are not yet present. This Section should review international

experience with regard to the various pillars, both successful and less successful implementation and lessons learned.

Tables and graphs should be provided of replacement ratios under various scenarios. It should discuss the issue of compulsory versus voluntary participation, as well as automatic enrolment with opting out and examine experience in this regard, to the extent that data supporting such analysis is readily available.

This Section should outline a variety of options for future pension provision and evaluate these options in terms of the evaluation criteria described above.

Additional international comparisons could be shown in appendices.

Section 4 – Demographic and social changes expected – international comparisons

This Section should outline recent economic and demographic developments in Bangladesh, including any specific features such as urbanization and migration, and how these trends may have affected old age income security and how they are likely to affect this in the future.

Based on a literature search and other sources, expected social changes (e.g. the reduction in agricultural sector, greater urbanization etc.) which have been witnessed at Bangladesh's state of development should also be discussed in this section. This discussion might include impacts which such changes could have on the pension system.

Section 5 – Issues related to current system

This Section should describe the current systems in place. At this point a baseline projection of the current system, with a variety of assumptions regarding demographic and economic assumptions, as well as the treatment of discretionary elements should be presented in summary form. Modelling should include long term fiscal balances for each component of the system as well as replacement ratios for typical participants.

Note: While actuarial input will be required in other sections of the White Paper, this section and the next will require the most concentrated actuarial inputs as models will need to be constructed demographic and economic data will need to be collected and validated. These models will then need to be used to examine the effects of parametric and systemic changes ("scenario analysis").

An international comparison of basic universal pension provision and supplementary pensions for civil servants and other employees, as well as individual tax assisted savings should also be presented in this section.

Section 6 – Options for reform

This is a key Section and will discuss a range of reform options for all the components of the system. The discussion would include both qualitative and quantitative analysis and long-term costing. Again, costing should be performed for reforms proposed to the social security elements of the system, as well as the civil servant element, by appropriate models, and replacement ratios for typical participants.

Summary results should be shown in the body of the report with more detailed analysis in an Appendix.

Section 7 – Administrative, managerial, strategic issues

This Section should discuss contribution and collection issues and proposals to improve compliance, taking into account the nature of income tax and social security contribution collection constraints in Bangladesh. This analysis should look particularly at issues related to unregistered or under-registered employment and other labor market inefficiencies. It should also consider the ear-marking of the current contribution and make recommendations for improvements.

Section 8 – Options for regulatory environment for future pension system

Depending on components of the proposed pension system a system of pension regulation will be needed. This section will review various options related to pension regulation and supervision, for example a “compliance approach” versus “risk based supervision” for private pension plans. Another issue which would need to be discussed is the role of the regulatory agency in regard to government pension plan and potentially a universal social security program. In some jurisdictions such programs are exempted from regulation by the regulatory agency while in others such programs are fully or partially subject to pension regulation. This section would review experience in regard to this issue in various jurisdictions and propose an approach for the eventual system to be developed in Bangladesh.

Section 9 – Considerations for future development

This is a “blue sky” Section, which would discuss possible future developments, such as an invested pillar (either mandatory or voluntary), employer sponsored pension plans and tax-assisted individual savings. By comparing to the experience in relevant comparators, the Section will examine the current infrastructure in relation to capital markets and individual invested accounts, identify required infrastructure and recommend regulatory and other aspects which would need to be in place to ensure successful implementation.

Some estimate of funds generated through the funded elements of the various “pillars” should be provided, based on appropriate modeling and the pros and cons of various approaches.

Section 10 – Evaluation of options against criteria for success

This Section would effectively wrap up the analysis by proposing one or more structures for pensions and demonstrate how the key proposals would contribute to the success of the pension system and the overall socio-economic and developmental progress of Bangladesh.

Annex B - ADB involvement in Pensions in Bangladesh

1 ADB involvement in the pensions (and insurance) sectors in Bangladesh

1.1 TA 2033-BAN

TA 2033-BAN: *Study on Insurance Industry and Pension and Provident Fund Operations in Bangladesh (1993¹⁷ – 1999¹⁸)* was intended to provide advice to the Government on improving the operational and management efficiency and financial structure of JBC and SBC, strengthening the legal and regulatory framework for the insurance industry, achieving a more competitive environment for promoting the growth and development of the industry, and enhancing the capacity and capability of insurance companies and pension and provident funds to invest in the capital market. The scope of the TA included:

- Analysis of the structural, regulatory, and management problems impeding the insurance industry's efficient operations;
- Operational study and financial evaluation of JBC and SBC to recommend ways of strengthening their institutional capabilities and internal processes, and improving their efficiency in generating and using funds,
- Formulation of recommendations to increase participation of insurance companies and pension and provident funds in the capital market; and
- Preparation of a master plan for the sound development of the industry.

TA 2033-BAN recommended legal and regulatory reforms and drafted amendments to the Insurance Act of 1938, the Insurance Rules of 1958, and Insurance Corporation Act, 1973.

Based on the recommendations of TA 2033-BAN, both the Insurance and Trusts Acts were amended to allow for greater participation of insurance companies and private pension and provident funds in the capital markets.

The Insurance Act was amended in 2000 to reduce the requirement for mandatory investments by insurance companies in government securities and government approved securities and investments to 30 percent of total investible funds.

The Trusts (Amendment) Act, 2000 was adopted to allow up to 25 percent of private pension and provident funds to be invested in capital markets instruments – i.e. any security listed with a stock exchange.

¹⁷ Approval
¹⁸ Completion

The Trusts Act, 1882, as amended by the Trusts (Amendment) Act, 2000

Section 20B - Investment of trust-money in company securities

(1) Where the trust property comprises money and it cannot be applied immediately to the purposes of the trust, the trustee may, subject to any prohibition or restriction imposed in the instrument of trust, invest an amount not exceeding 25% of such money, hereinafter referred to in this section as the maximum limit of investment, in any security listed with a stock exchange of Bangladesh.

(2) In determining the exact amount of money that may be invested under sub-section (1) at any given time, the money already invested, if any, under this section and also under 20(f) shall be deducted from the maximum limit of investment at that time.

(3) Nothing in this section shall be construed to be a bar to authorize the investment of trust-money by the author of the trust beyond the maximum limit of investment.]

Due to the Executing Agency's¹⁹ "lack of interest", and the "limited time allocated by the consultants", the TA output for pensions and provident funds was rated by the TA Completion Report as "inadequate", and the overall assessment of the TA was rated as only "partially successful".²⁰ According to the project's TA Completion Report (TACR), major lessons to be learned from the implementation of TA 2033-BAN included:

- Strong Government ownership is the key to success of the TA. The Ministry of Finance, or its designated department, should have been deeply involved with the TA, as part of a steering committee and as implementing agency for pension and provident fund part of the TA.
- There should have been a systematic way of ensuring that there was Government reaction to the results of the studies within a reasonable timeframe.

1.2 TA 2915-BAN

A follow-on technical assistance project, TA 2915: *Insurance Industry and Pension and Provident Fund Reforms* (1997), provided as a "piggy-back" to the Capital Market Development Program (CMDP) Loan, was designed to provide greater emphasis on pensions and included an actuarial valuation of the Government pension fund and exploring the establishment of a central provident fund. The TA made actuarial estimates of future government pension liabilities and calculated the cost of shifting to a fully funded system. TA 2915-BAN also provided insurance training through the Bangladesh Insurance Academy (BIA) and outlined an early warning system for the Department of Insurance.

The major outputs from the TA were:

¹⁹ Ministry of Commerce

²⁰ ADB TA Completion Report for TA 2033-BAN: Study on Insurance Industry and Pension and Provident Fund Operations in Bangladesh, Asian Development Bank (TACR attached as Appendix __)

- An early warning system for monitoring the performance of insurance companies;
- An actuarial analysis on the GPS;
- A proposed central provident fund;
- A proposal for revision of investment guidelines for contractual savings institutions; and
- A nine-day seminar on "Sound Business and Financial Practices in Insurance."

According to the project's TA Completion Report (TACR)²¹ The actuarial assessment of the "pay-as-you-go" Government Pension Scheme (GPS) showed an increasing fiscal burden of unfunded pension liabilities that could, potentially, lead to a fiscal crisis in the future. The required annual charge to the Government to finance its pension scheme was estimated at one-fourth of the Government's current expenditures. Alternative solutions to address this issue were suggested. The TA recommended a central provident fund for the formal private sector with possible application to the public sector. However, the rationale for this recommendation was not adequately provided and its applicability to Bangladesh was debatable.

The TACR rated the overall performance of the project as "partly successful", indicating that "solid" technical outputs were produced, but that the consultants did not provide adequate rationale for some of their recommendations. Deficiencies were also cited in the process of consultation, presentation, review, and feedback. The TACR suggested that TA resources could have been more effectively utilized to promote and support the development of the insurance, pension and provident funds sectors.

On the positive side, a greater awareness among government officials of the problems and issues in these sectors was cited, as evidenced by the formation of a Government committee to recommend measures to reform the insurance industry.

According to the project's TA Completion Report (TACR), major lessons to be learned from the implementation of TA 2915 included:

- Strong commitment from the Government is key to the success of TA implementation. At the outset there were signs of weak commitment. At the time when TA implementation started in early 1999, more than two years after the consultant's final report for TA 2033-BAN was submitted in 1996, no feedback from the Government had been received on the proposed regulatory reform for the insurance sector;

²¹ *Technical Assistance Completion Report, TA 2915-BAN: Insurance Industry and Pension and Provident Fund Reforms*, Asian Development Bank

- Any follow-on TA should be provided based on the satisfactory progress with the implementation of recommended actions from the previous TA and strong commitment from the Government and the concerned ministries;
- Having a TA covering two distinct (albeit related) sectors, one of which did not fall under the responsibility of the Executing Agency (Ministry of Commerce), was problematic. The EA (which was responsible for the Department of Insurance) was reported to have shown little interest in the pension aspect of the project. Although the MoF was the Implementing Agency (IA) for the pension and provident fund part of the TA, it was reportedly not “deeply involved”, as it “did not see itself as owner of the TA”. The interest of MoC is reported to have “declined” when it was decided to emphasize the focus of the TA on pension/provident funds.

1.3 Subsequent Engagement

A project loan (Public Pension and Insurance Governance and Administration Project) for \$50-70 million was proposed by ADB for 2003 to address public pensions. On the request of the Government, a Project Preparation Technical Assistance (PPTA) Project (3590-BAN: Pension and Insurance Sector Project²²) was approved by ADB in December, 2000. This TA was intended to prepare a possible loan project to develop the policy and legal framework, build capacity to regulate and supervise the insurance and pension sector, to extend its coverage, and assist with the transition cost in establishing a multi-pillar pension system.

However, in response to the Government's request for addressing the adverse implications of the impending termination of the Multifiber Agreement (MFA) at the end of 2004, an SME Development and Financing Project was added in the 2003 lending program and, accordingly, the Public Pension and Insurance Governance and Administration Project was postponed. PPTA 3590-BAN was subsequently cancelled.²³

ADB's Country Assistance Strategies since 2003 have not programmed any lending in support of pension reform.

²² *Technical Assistance (Financed from the Japan Special Fund) to the People's Republic of Bangladesh for Preparing the Pension and Insurance Sector Project*, Asian Development Bank, December, 2000

²³ *Bangladesh Country Strategy and Program Update (2002-2004)*, Asian Development Bank, July 2001

APPENDIX 6

PRIVATE EQUITY AND VENTURE CAPITAL

APPENDIX 6: Private Equity and Venture Capital

1	Definition of Private Equity and Typical Structures.....	1
2	Why Private Equity can play an important role in Bangladesh.....	1
3	Private Equity in Bangladesh.....	3
3.1	Background and Historical Perspective	3
3.2	Private Sector Market Participants	4
3.3	Size of the Bangladesh Private Equity Industry.....	5
3.4	Typical Structures in Bangladesh for Funds and Investments into Investee Companies	5
3.5	Regulatory Environment.....	5
4	Constraints to the development of Private Equity and Venture Capital.....	6
4.1	Demand Side Constraints	6
4.2	Supply Side Constraints.....	7
5	Areas for Policy Development and Reform in CMDP III	9
5.1	Fund Investors	10
5.2	Appropriate financial Instruments to balance risk and reward.....	10
5.3	Exits.....	11
5.4	Recognition of Foreign Private Equity Funds	13
5.5	Arbitration and Contract Enforcement	13
6	A Suggested Policy Road Map	14

APPENDIX 6: Private Equity and Venture Capital

1 Definition of Private Equity and Typical Structures

Private equity is medium to long-term finance provided in return for an equity stake in potentially high growth unquoted companies. Some commentators use the term “private equity” to refer only to the buy-out and buy-in investment sector. Others, in Europe but not the USA, use the term “venture capital” to cover all stages, i.e. synonymous with “private equity”. In the USA “venture capital” refers only to investments in early stage and expanding companies. To avoid confusion, the term “private equity” is used to describe the industry as a whole, encompassing both “venture capital” (the seed to expansion stages of investment) and management buy-out and buy-ins. In Bangladesh, much like in other frontier markets private equity tends to fall into a sub categories of venture capital and growth capital.

The private equity market is an important source of funds for start-up firms, private middle-market firms, firms in, and public firms seeking buy out financing. Over the past twenty years it has been the fastest growing market for corporate finance, by an order of magnitude over other markets such as the public equity and bond markets and the market for private placement debt.

Globally, typical funds structures for private equity are usually organized as limited partnerships with investors (the limited partners) providing capital and the managers of the fund serving as the general partners. A common private equity fund structure includes two management-related entities, a general partner and an investment manager. The managers of a private equity fund, through the general partner and investment manager, are responsible for making all decisions surrounding the activities of the fund, including acquisitions, capital calls, divestitures, etc. In exchange for this oversight, the managers receive a management fee and a carried interest. Conversely, the investors in the private equity fund (i.e., the limited partners) receive a preferred return on their contributed capital, which accrues until the fund begins making distributions¹. Private Equity funds are typically close ended funds with fund life being around 7-12 years, usually without redemption rights for limited partners investing in the fund, until the fund is dissolved at its maturity.

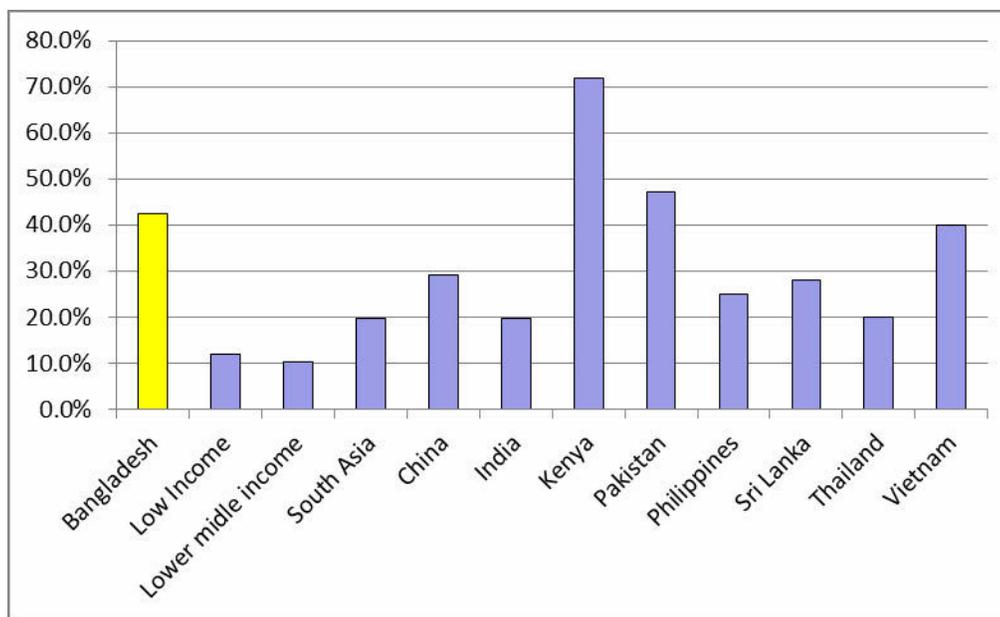
2 Why Private Equity can play an important role in Bangladesh

Access to Finance remains limited even for the largest firms with limitations on quantity and price of lending: According the World Bank (WB) Second Investment Climate Report, access to finance is tight. More than 40% of firms nationwide agree that access to finance is a major or severe obstacle to business, a higher percentage than the

¹ <http://www.srr.com/article/carried-interest-and-performance-fee-incentives>

average for low and lower-income countries, and the highest in the region after Pakistan.

Figure 1 – Access to finance is a major obstacle (% of firms agree, by country)



Source: World Bank

As a result, firms in Bangladesh need to use internal savings to finance investment-internal sources fund 70% of firm investment in Bangladesh, as opposed to lower shares in the region).

Medium and long-term credit is scarce: The WB reported that in urban areas, 69% of lending has a maturity of less than three years. A little less than half of the loans have maturities of one year. As a result, long term financing is typically procured through accumulated earnings, and firms tend to under-invest. Companies also often resort to financing longer term assets with short term financing causing asset-liability mismatches and sub-optimal capital structures increasing financial risk. Some companies rollover existing loans, which can be destabilizing to the financial system.

Absence of risk capital suggests role for PE investors: The over-collateralization of lending is one factor behind the constraint in access to finance. The absence of a risk-based lending system where lending is based in part based on the future cash flows and operating prospects for the business over existing collateral such as land or assets of affiliated businesses is a major constraint on the development of new entrepreneurs which typically are “asset light”. More broadly, early and growth stage businesses are not always suitable for debt financing due to cash flow characteristics. PE investors can

bring new risk capital to companies and can play an important role in facilitating access to finance.

Lending is over-collateralized given informational asymmetries: Credit information in the country is inadequate and unreliable so banks have to rely on collateral to provide security for the loans. The WB also notes that a lack of credit information on customers and an ineffective legal system for contract enforcement means that banks are not willing to lend without very secure collateral.

Cost of debt financing is high: The cost of debt financing in Bangladesh is very high and can be above 15% and above. This is particularly onerous for developing businesses where cash flows are unpredictable or do not support such high servicing costs. For new and developing business private equity is often a more sustainable option relieving business from having to pay high financing costs.

Development of the Private Sector could attract more foreign investment: Bangladesh has historically attracted relatively low levels of FDI averaging around USD500mn per year and being dominated by the Telecoms sector. In 2013 levels increased to over USD1bn. Development of a private equity industry would attract further foreign capital, which is imperative to improve the investment rate and growth in the economy.

Foreign Private Equity could improve businesses in multiple ways: Private equity provides more than just financing. Foreign Private Equity can catalyze improvements in corporate governance, improvements in management quality, financial reporting, tax compliance, ESG compliance, linkages to global markets both financial and strategic, access to cutting edge technology and skills.

3 Private Equity in Bangladesh

3.1 Background and Historical Perspective

The Private Equity industry (including venture capital) in Bangladesh is still largely at a nascent stage with around only USD150-200mn² of committed capital from Bangladesh focused private equity and venture capital funds. Prior to 2008, the majority of PE activity had originated in a very limited way from the three major developmental finance agencies, namely, the IFC (part of World Bank Group), CDC (UK) and DEG (Germany)³. There were direct investments in to the power and infrastructure sector, into Lafarge Cement⁴, the financial sector notably IPDC and IDLC⁵, and selectively into

²This relates to the Frontier Fund (Brummer) and SEAF funds under management. Discussions with Frontier Fund and SEAF management and estimates of funds under management/invested capital from EEF, Sabinco and UBICO

³Discussions with IFC, CDC and DEG

⁴Discussions with Lafarge management

⁵Discussions with IDLC and IPDC management

the textile sector. Aureos South Asia Fund (an offshoot of CDC) also invested into Apollo Hospitals⁶. In terms of domestic institutions, SABINCO (a joint venture between the Saudi and Bangladesh Governments) and UBICO (likewise a JV between the UAE Government and BD) has made PE investments, Sabinco played an important role in the development of agro food processing in partially financing Pran, a leading local food company, as well as investments in the aquaculture sector.⁷ In 2001, Bangladesh Bank introduced the Equity and Entrepreneurship Fund ('EEF'), which provides equity financing to encourage entrepreneurship in the IT/Software industry and Food Processing and agro-based industry. EEF invests in new projects requiring total financing of between BDT 5mn and BDT 50mn for IT/Software and BDT 100mn in agro/food processing⁸.

But such PE investment was at best ad hoc with ongoing concerns about corporate governance; the lack of willingness of local entrepreneurs to give up equity; limited exit opportunities given the small size of the stock market, the relatively modest number of sizeable IPOs, the under developed institutional market, lack of confidence in company balance sheets and a limited investment banking sector that could source deals and analyze opportunities. The bulk of foreign institutions have a greater proportion of their assets in the form of long-term debt rather than equity.

3.2 Private Sector Market Participants

Since 2008, new players in the private equity space in Bangladesh started operations:

- In 2008, Venture Investments Partners Bangladesh (VIPB) commenced operations – it was a fund set up by an ex World Bank team member, with LP funding coming from a collective of local banks and insurance companies, providing Taka funds for investments into SME ventures. While it started out with the intention to make equity investments, it then changed to making convertible preference share investments, much like debt but with the option of conversion – while this instrument is often used as downside protection for investors prior to conversion to equity, the main objective of VIPB is to collect yield on the instrument and redeem before conversion.
- In 2009, the Frontier Fund (owned by Brummer & Co, a Swedish fixed income hedge fund) started operations in Bangladesh with a USD 90mn private equity fund focusing on growth capital investments. The fund LPs were largely DFIs including the IFC, CDC and FMO. The Frontier Fund has nearly committed all its capital from its first fund to investments in the Grocery Retail, Pharmaceuticals,

⁶Discussions with Aureos management

⁷Discussions with Sabinco management

⁸ Bangladesh Bank Website: http://www.bb.org.bd/aboutus/dept/dept_details.php

RMG, Electrical Goods Retailing sectors, and is in process of raising funds for its second Fund.

- In 2012, the IFC launched a program for SME venture capital financing, with USD12mn allocated to SEAF, an emerging markets fund manager, who started operations in Bangladesh with this seed funding.
- In 2013, BD Ventures a locally incorporated company, owned by various individuals (company owners and professionals) intend to make relative small local taka equity investments into SMEs.

3.3 Size of the Bangladesh Private Equity Industry

We estimate the total funds under management from both domestic and international funds to Bangladesh is in the region of USD 150-200mn, with the largest contribution to this being the Frontier Fund with c USD 90mn of deployed capital.⁹

3.4 Typical Structures in Bangladesh for Funds and Investments into Investee Companies

In Bangladesh, domestic private equity providers such as UBICO and Sabinco (as discussed below), both are limited companies regulated by Bangladesh Bank as Financial Institutions, have raised their paid up capital and made direct equity investments from their balance sheets, into investee companies. We would note that in the absence of any specific private equity rules or policies, such structures are used largely because of the absence of any vehicles/structures tailored for or having any specific regulatory or fiscal benefits afforded to Private Equity providers.

International private equity providers such as the Frontier Fund are arranged as limited partnerships with investors (the limited partners) providing capital and the managers of the fund serving as the general partners, with the fund being domiciled in tax efficient jurisdictions, in this case Mauritius.

Both international and domestic private equity providers invest in the common equity and/or convertible preference shares directly into the investee companies.

3.5 Regulatory Environment

The Private Equity industry does not have specific policies and regulations afforded to it and is subject to general policies, laws and regulations as detailed below:

- The Companies Act 1994, provisions relating to all companies.

⁹ This relates to the Frontier Fund (Brummer), SEAF, and estimates of funds under management/invested capital from EEF, Sabinco and UBICO.

- Income Tax Act 1984, Stamp Duty Act - taxation rules applicable to all companies.
- Trust Act 1882, provisions relating to all trusts. We would note that for the Mutual Fund industry, the NBR provides exemption from tax at Fund level for institutional investors. Private Equity, given there is no policy or act, does not receive any tax exemption if a Trust is used for Private Equity.
- Foreign Exchange Regulations (Chapter 9), provisions relating to repatriation, only applicable to foreign domiciled private equity funds.
- Mutual Fund Act 2001, in particular Circular, Amendment of Mutual Fund Act 2001, (Ref: SEC/CMRRCD/2006-157/143/Admin/47), the scope of the types of funds/fund management services licensed Asset Management Companies could offer was expanded to include Collective Investment Scheme(Rule 2 DhaDha) and Special Purpose Fund (Rule 2 DhaDhaDha). Such vehicles could technically include private equity funds. The Circular however remained silent on tax treatment and if there is a requirement to list the fund, as is required for Mutual Funds under the Mutual Fund Act 2001. We would note that the act covers only Asset Management Companies and therefore private equity managers without Asset Management licenses fall out with the scope of the Mutual Fund Act 2001.

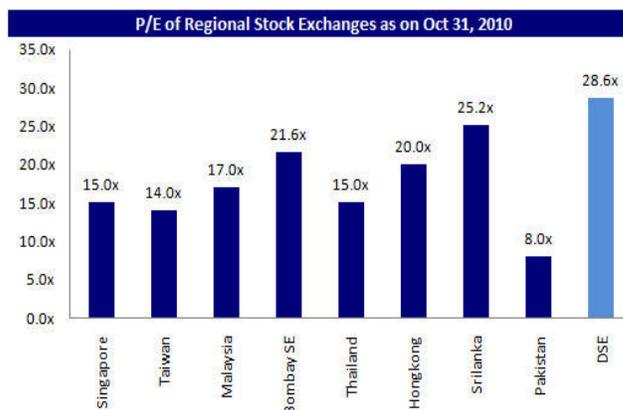
4 Constraints to the development of Private Equity and Venture Capital

Following meetings with Private Equity market participants we have detailed key demand and supply constraints. A list of people met/interviewed is included in Appendix 1 of this report.

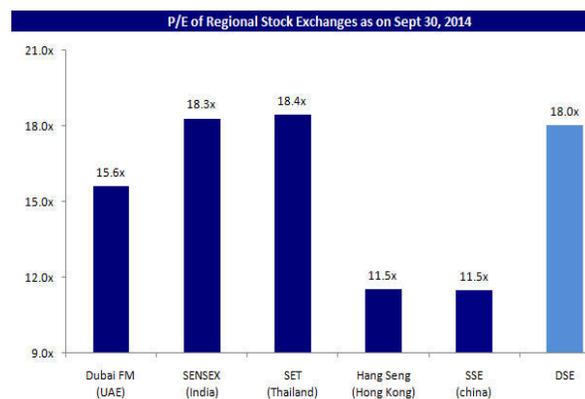
4.1 Demand Side Constraints

- **Culture of maintaining ownership/control and not giving up equity:** Most corporates in Bangladesh are still family owned with succession expected to go to family members. Key concerns for corporates are maintaining control, non-dilution of earnings distribution, lack of trust of new shareholders/directors and concerns around maintaining proper accounting records and tax compliance.
- **Access to loans available to larger businesses:** Business owners naturally prefer to avail debt rather than giving up equity as perceived cost of equity is significantly higher than debt even at high rates and low tenures. This is causing high and expensive leverage and asset-liability mismatches.
- **When Public market valuations are high they can be a more attractive option of raising finance for businesses:** Business owners often prefer to raise equity financing at the best possible valuations. When stock market valuations are

high (e.g. at the peak of the stock market in 2010 the market PE was around 30x, currently it is 15x), private equity investors may not be able to compete with valuations offered by the stock market for fundraisings. However as noted below, public market valuations are currently lower since market peak in 2010.



Source: AT Capital Research, DSE



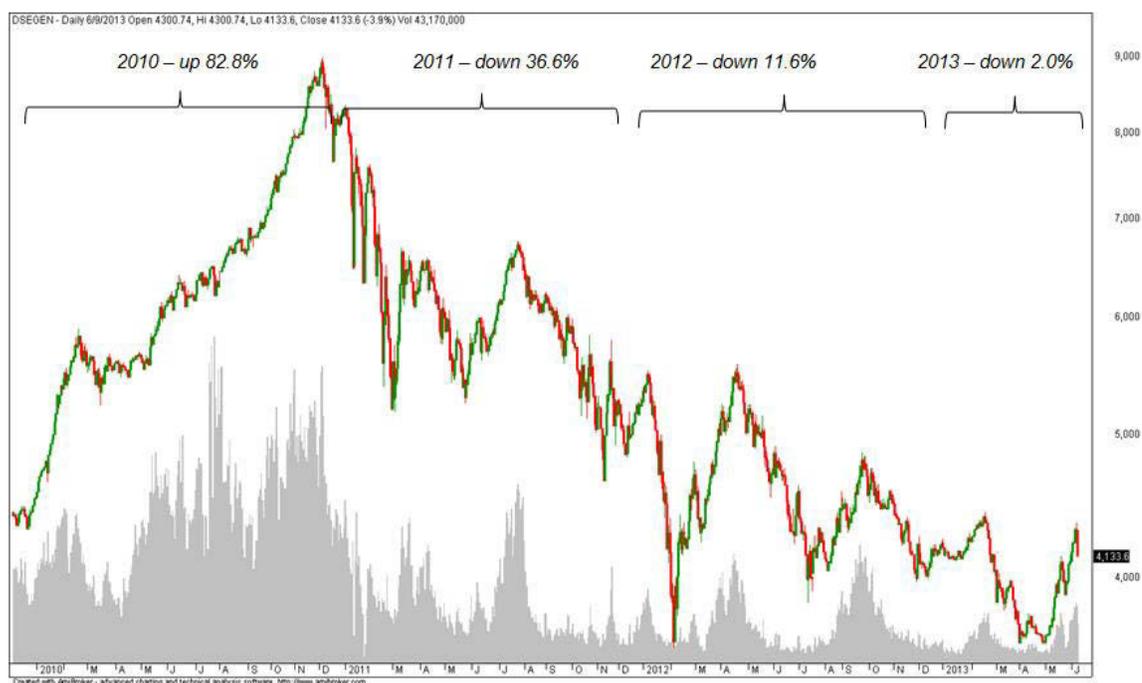
Source: AT Capital Research, DSE

- Lack of knowledge of Private Equity and Venture Capital:** Given the relatively newness of private equity in Bangladesh, corporates largely still view private equity as a simply an alternative source of financing to debt rather than a true partnership providing broader benefits such as improved corporate governance, strategic direction, access to broader ranges of financing, optimization of capital structure, market access and improved valuation of their business.

4.2 Supply Side Constraints

- Corporate Governance:** Most businesses are still family owned and have not had to develop their corporate governance.
- Legal Protection and Lack of Enforcement of contract:** The legal system remains weak, in terms of both regulation and enforcement of contracts, increasing in particular exit risk and non-compliance of contract terms.
- Lack of reliability of financial statements and Tax compliance:** Many companies in Bangladesh still maintain two sets of books—the real accounts, and accounts for statutory compliance and tax submissions, often under-reporting earnings to evade tax.
- Stretched valuation expectations:** As noted above at the peak of the stock market in 2010 the market PE was around 30x, with it dropping to 15x currently. Given the longer tenure of Private equity investments of around 5 years, it is important that entry valuation multiples are not significantly higher than forecast

exit multiples. While valuations are currently more reasonable than the peak in 2010, there remains volatility in the stock market. While some business owners believe the market will rise back to its peak, other business owners are now understanding that previous pre2010 valuations were in an environment of an asset price bubble. As such pricing expectations are more reasonable currently in line with the market cycle.



Source: AT Capital Research, DSE

- Limited exit options:** While Private Equity funds can exit through both IPOs and disposals, we would note both domestic and international M&A remains relatively undeveloped in Bangladesh. IPO environment can be uncertain and delayed, negatively impacting exit IRRs.
- IPO Exit Valuation Methodology:** Currently the BSEC allow two approved methods for IPOs – firstly, the fixed price methodology, which uses various valuation methodologies provided by the company and the appointed issue manager, and approved by the BSEC. Secondly, book building is allowed, which is effectively a market driven valuation using a price discovery method by eligible investors. However we would note after concerns in the operation of the book building method up to the 2010 market correction, book building has been largely inactive, although we would note that two IPOs currently in process intend to use the book building methodology. The concern for investors and indeed shareholders of companies is that the fixed methodology may result in the under valuation of companies when raising capital. The table

details the pricing of IPOs in 2013 and 2014, which used fixed price method, comparing the IPO valuation to the post IPO trading valuations - in most cases the IPO valuation is less than the post listing trading valuation.

- Lack of Professional Management:** As discussed above businesses are often family owned with key management decision making made by family members. This has led to unempowered management, which has hindered, along with poor business education, the development of professional managers leading businesses and driving growth.

Companies	P/E at IPO	Post IPO P/E
2013		
Orion Pharma	10.8x	13.3x
Bengal Windsor Thermoplastic	7.1x	21.6x
FamilyTex (BD) Limited	10.9x	41.7x
Central Pharmaceuticals Limited	8.3x	35.8x
Fareast Finance & Investment Ltd.	9.6x	8.3x
Bangladesh Building System Ltd.	3.9x	26.2x
Paramount Textile Limited	8.1x	7.1x
Appollo Ispat Complex Limited	9.3x	n/a
Mozaffar Hossain Spinning Mills	3.6x	9.2x
AFC Agro Biotech Limited	9.9x	52.8x
2014		
Matin Spinning Mills Limited	9.3x	9.0x
Emerald Oil Industries Limited	3.5x	15.9x
Hwa Well Textiles (BD) Limited	2.7x	10.9x
Far Chemical Industries Limited	2.0x	6.9x
The Peninsula Chittagong Limited	12.0x	12.5x
Shahjibazar Power Co. Ltd	10.8x	146.0x
Khulna Printing & Packaging Limited	3.5x	11.2x
Far East Knitting & Dyeing Industries Limited	10.6x	11.3x
Tung Hai Knitting & Dyeing Limited	7.2x	12.3x
Shurwid Industries Limited	9.2x	37.7x
Saif Powertec Limited	14.9x	37.8x
Ratanpur Steel Re-Rolling Mills Limited	7.1x	12.2x
Western Marine Shipyard Limited	16.7x	35.7x
Khan Brothers PP Woven Bag Industries Ltd.	6.0x	45.9x

5 Areas for Policy Development and Reform in CMDP III

Private Equity and Venture Capital firms are currently operating without any specific regulatory regime for the sector, but working within parameters provided by general laws and regulations, some of which are prohibitive to the functioning and development of the Private Equity and Venture Capital in Bangladesh. In particular we would highlight issues around repatriation of capital for foreign private equity investors, lock-in periods after IPO and issues of double taxation incorporate holding structures. Following meetings with Private Equity/Venture Capital market participants (see Appendix 1 for List of People Met/Interviewed) we have detailed key areas requiring development and reform.

Awareness and capacity building for corporates, market participants and regulators:

Currently as Private Equity is such a new area in Bangladesh there is a need for all stakeholders to understand the sector, how it operates and its objectives including matters such as how private equity investors view entry and exit valuations relative to trading valuations in the stock market.

Association for Private Equity and Venture Capital: The formation of an association for PE firms will provide a forum to collectively address common interests and issues.

Development of Private Equity Promotion Policy: Such policy should identify areas where current policies, laws and regulations prohibit the development of private equity and aim to address such issues. We would emphasize that such a policy should focus on removing impediments for the development of PE, both local and foreign, in Bangladesh and not introduce new restrictions. Key areas that may be addressed by such a policy are addressed in sections below.

5.1 Fund Investors

On shore PE Fund Structures and Tax Treatment-Trusts are a recognized structure in Bangladesh as investment vehicles e.g. mutual funds. While the structure is appropriate for Private Equity broadly speaking, the taxation treatment can be unclear and potentially onerous for Private Equity investors due to double taxation at both fund and investor level.

Recommendation: Trusts may be used for domestic private equity funds. It is important that they will be treated as 'pass through' entities for tax purposes to ensure there is no double taxation at fund and investor level.

Expanding On shore Fund Investor Base-Removal of barriers/incentives for domestic Insurance Companies/Pension Funds to invest in domestic PE Funds

Recommendation: Life Insurance companies and Pension Funds should be encouraged to invest in private equity funds. We would recommend that stakeholder engagement programmes are conducted to improve awareness of private equity as an investment product for Life Insurance and Pension Funds.

Offshore Fund Investors-Fund domicile countries who do not have double taxation treaties with Bangladesh may result in double taxation for investors.

Recommendation: Bangladesh should ensure it has double taxation treaties countries and jurisdictions that are used globally as fund domiciles.

5.2 Appropriate financial Instruments to balance risk and reward

Domestic Private Equity- As repatriation is not an issue for domestic Private Equity funds, they can make investments in equity, preference shares, convertible preference shares, bonds and debt

Foreign Private Equity-an important consideration for foreign private equity investors is their ability to repatriate capital. In the Bangladesh context the only instruments foreign investors can use where they can repatriate investment/proceeds without regulatory approvals are equity and convertible preference shares.

Recommendation: Foreign private equity funds would ideally like to invest in instruments such as bond/debt/hybrid/mezzanine investments without the need for additional approvals required for repatriation. However as discussed below with regards to convertible preference shares, if repatriation is clarified for convertible preference shares, we would suggest that this would be sufficient for investors currently given the ability to structure convertible preference shares with a variety of features meeting their needs. We would however suggest bond/debt/hybrid/mezzanine investments could be considered in the future as the private equity sector develops in Bangladesh.

5.3 Exits

IPO Lock-In Periods/ Definition of sponsor- Normally equity investors in a company are treated as 'sponsors', with the exception of 'Pre-IPO investors'. Sponsors are subject to lock-in for 3 years post IPO. 'Pre-IPO investors' area defined group of investors who are invited to invest in the equity of a company just prior to an imminent IPO approved by the BSEC. Pre-IPO investors who hold less than 5% of the company's equity are only subject to a 1 year lock-in, while those who hold more than 5% are subject to a 3 year lock-in (Bangladesh Securities and Exchange Commission (Public Issue) Rules-2006-Clause 9 (Lock in Provision)). Private equity investors who invest in company who is not planning to IPO imminently are treated as sponsors and if they hold more than 5% of the company's shareholding are therefore subject to a three year lock-in. This effectively extends the investment duration for private equity investors which may make such investments less attractive or not possible.

Recommendation: We would suggest private equity investors are not treated as sponsors and subject to a 3 year lock-in, but instead subject to a 1 year lock-in or no lock-in at all. We would emphasis that for Foreign Private Equity investors this is extremely important for them, and would suggest at the very least they are provided a 1 year lock in or no lock in at all.

IPO Valuation- Under current IPO methodology as IPO valuations need to be approved by the BSEC, there is a concern amongst Private Equity players that exit IPO valuations may be below market levels as regulators may take a conservative stance. This makes it difficult for Private Equity firms to assess prospective investment returns. Private Equity firms would welcome a methodology that is consistent with fair market value.

Recommendation: We would suggest that IPO valuations should be conducted at fair market value determined by market based processes of book building.

*Double Taxation-*Due to corporate entities being taxed at each level with withholding taxation on dividends, private equity investors may suffer double taxation through their holding structures.

Recommendation: We would suggest that where it is clear that structures are in place as pass through entities they should not be subject to double taxation.

Repatriation for Foreign Funds/International M&A-In Bangladesh exits can take the form of IPOs and disposals (including sponsor share buybacks). However, the foreign exchange regulations make certain exits unadvisable due to repatriation restrictions. We would note the following:

- Listed company share disposals i.e. after IPO: the full amount of sales proceeds may be repatriated without Bangladesh Bank permission.
- Domestic Sale of shares in a non-listed company: to be able to repatriate the sales proceeds, one requires approval from Bangladesh Bank. On 31 August 2014, Bangladesh Bank issued a circular (FE Circular No 32 (referring to Paragraph 3(B), Chapter 9 of the Guidelines for Foreign Exchange Transactions 2009)) where they expanded valuation methodologies to be used to include three methods – net asset value approach, market value approach and discounted cash flow approach - as acceptable methods and would seek that repatriation applications are supported by a valuation certificate provided by eligible valuers i.e. BSEC registered Merchant Banks or Chartered Accountancy Firms.
- Offshore sale of shares: this exit route entails a foreign entity purchasing the shares of a company offshore and therefore does not give rise to repatriation issues for foreign private equity investors.
- Convertible Cumulative – Redeemable Preference Share Repatriations: Convertible Preference Shares are an attractive investment instruments for private equity investors as they perform a hybrid function, initially much like debt with an agreed coupon and redemption but also with the ability to convert to equity at their discretion. We also understand that private equity investors are using Convertible Preference shares as investment instruments as they have obtained legal advice that such instruments are treated as 'equity' by GoB regulators (e.g. Bangladesh Bank, BSEC, NBR) – this means that coupons are treated much like dividends for repatriation purposes (i.e. they do not need approval from Bangladesh Bank to repatriate) and redemption of principal is treated as capital repatriation much like equity (i.e. subject to Foreign Exchange regulations for equity sale and repatriation as discussed above, limiting the repatriation to the net asset value on the balance sheet). We would note that while private equity investors are using such instruments, they are doing so on the basis of legal opinion and remain unclear if they will be permitted to repatriate coupons and principal due to a lack of clarity in the regulations and a lack of any precedents of this being permitted.

Recommendation: We would suggest there is a need for clarification that Convertible Redeemable Preference shares can be repatriated without need for regulatory approval. We would advise this would be appropriately included in the Foreign Exchange Regulations (Chapter 9) that are silent on repatriation of convertible preference shares.

- Repatriation of capital if IPO does not happen: In some instances there have been investments made by foreign private equity funds where the investee company has failed to IPO and private equity funds have relied on sponsor buy back options / tried to repatriate their initial equity investment. However, this requires the investee company to apply to Bangladesh Bank for permission to remit the capital which has been problematic where the company has been unwilling to do so when a dispute has arisen between the private equity fund and the investee company.

Recommendation: We would suggest a mechanism is developed where by the private equity investor can apply to Bangladesh Bank in such instances.

5.4 Recognition of Foreign Private Equity Funds

As detailed above there are some suggested recommendations, which would apply to Foreign Private Equity investors, in particular relating to repatriation of convertible preference shares and reduced IPO lock in period for foreign private equity investors. As such a process should be developed whereby Foreign Private Equity investors should be recognised to avail the recommendations detailed above. We would suggest that BSEC may provide such recognition by registering Foreign Private Equity Funds by developing criteria for registration. Having reviewed the Indian regulations a key component of such criteria is a certificate of registration as a private equity fund from the 'home regulator' and also 'fit and proper person' declaration.

Recommendation: We suggest Foreign Private Equity Funds are recognized so they can qualify for certain regulations aimed at them. Criteria for registration as a Foreign Private Equity Fund would include certificate of registration as a private equity fund from the 'home regulator' and also 'fit and proper person' declaration.

5.5 Arbitration and Contract Enforcement

Arbitration and contract enforcement for Private Equity and Venture Capital may come under the purview of the soon to be formed Capital Markets Tribunal.

6 A Suggested Policy Road Map

Table 1 – Policy Road Map

Phase	Key Objectives	Target Completion Date
Phase I	Awareness and Capacity building for corporates, market participants and regulators Formation of Association for Private Equity and Venture Capital.	
Phase II	Development of Private Equity Promotion Policy Priority policy issues: <ol style="list-style-type: none"> 1. IPO Lock In Period need to be reduced for recognized Private Equity Firms 2. Repatriation of convertible preference shares if conversion does not happen and Repatriation of capital if IPO does not happen 3. Recognition of Foreign Private Equity funds 4. IPO valuation methodology aligned to fair market value 5. Development of appropriate fund framework and structure for Domestic Private Equity Funds 6. Clarification and development of double taxation treatment at fund level and for fund investors pursuant to encouraging the development of the Private Equity sector 7. Contract Enforcement for Private Equity and Venture Capital 	

APPENDIX 7

DERIVATIVES AND FINANCIAL MARKET INFRASTRUCTURE

APPENDIX 7: Derivatives and Financial Market Infrastructure

1	Background	1
1.1	Market Structure	1
1.2	Typical Instruments	3
1.2.1	Forward-based Instruments	3
1.2.2	Options	3
1.3	Typical Motivations of Derivatives Traders	4
1.3.1	Hedging as a Primary Objective	4
1.3.2	Speculating as a Primary Objective	4
1.3.3	Dealing as a Primary Objective	4
1.4	Market Infrastructure: The Central Counterparty (CCP) – a vital component	5
2	Benchmarking - Emergence of Exchange-Traded Derivative Markets	6
3	The Current Situation in Bangladesh	7
3.1	Current Approaches to Managing Risk	7
3.1.1	Interest Rate Risk	7
3.1.2	Foreign Exchange Risk	8
3.2	Considerations for Introducing Derivatives	8
3.2.1	Market Structure	8
3.2.2	Products/Instruments – Range and Sequencing	9
3.2.3	Financial Market Infrastructure	12
3.2.4	The Primary Regulatory Authority	12
3.3	Recent Developments	13
3.3.1	Regulatory/Policy Developments	13
3.3.2	The Emergence of Potential Market Operators (sponsoring groups)	14
3.3.3	Developments in the Government Securities Markets	14
4	Potential Opportunities for ADB Support	14
4.1	Demand Study	15
4.2	White/Policy Paper	15
4.3	BSEC Strategic Plans	15
4.4	Development of a Sustainable Central Counter Party (CCP) to Support a Derivatives Market	17

APPENDIX 7: Derivatives and Financial Market Infrastructure

1 Background

Derivatives are financial instruments that transfer risks from one party to another. They are called derivatives because they derive their value from the value of something else - an underlying right or interest. Underlying rights or interests can include bonds - which involve interest rate, credit, and currency risks - and commodities and equities - which involve price risks. Underlying rights or interests can also be groups of assets, such as equity, credit, or commodity indices, or *relationships* between prices, such as the spread between two benchmark government securities.

The growth in derivatives activity over the last two decades is considered to have yielded substantial benefits to a number of emerging market economies. Derivative trading can facilitate access of businesses to international capital, while lowering their cost of funds and diversifying their funding sources. It can improve the competitive position manufacturer exporters in an increasingly competitive global economy by reducing their exposure to foreign exchange risk and to the volatility input costs.

By providing firms with new and more effective tools for managing their exposure to various risks (e.g. adverse fluctuations in interest rates, foreign exchange rates, and commodity prices), derivatives can reduce the likelihood of financial distress due to volatile prices and interest rates.

With such incidental risk exposures under control, management is better able to focus on its core business - improving the quality and reducing the cost of its products. Similarly, by providing investors and issuers with a wide array of tools for managing risks and raising capital, derivatives can improve the allocation of capital and the sharing of risk in the economy, reducing the cost of capital formation, stabilizing employment, and stimulating economic growth.

Given the right conditions, derivatives can potentially contribute to the development of a country's financial sector by linking cash markets, hedgers and speculators. Derivatives can provide liquidity and price discovery mechanisms, transfer underlying risks among economic agents with varying and complementary preferences – transferring risks from those who wish to dispose of them, to those who are willing and able to incur them.

1.1 Market Structure

Derivatives markets can broadly be categorized into three types. *Exchange traded derivatives* (ETDs) involve the trading of highly standardized contracts through a central venue, typically clearing and settling (“booking”) transactions through a central clear-

inghouse that serves as a central counterparty (CCP). The contract specifications for listed derivatives are typically standardized to a relatively high degree, which facilitates trading and enhances liquidity. Execution through an exchange facilitates price discovery and transparency and affords anonymity of trade counterparties. The clearinghouse becomes the counterparty to all trades by a legal replacement of bilateral trades between anonymous counterparties with those between the clearing participants and the clearinghouse through a legal process known as “novation” (or its functional equivalent). As a result risk is “socialized” among clearinghouse participants.

A second category is *over-the-counter* (OTC) derivatives, which involve the bilateral trading of customized transactions privately negotiated and settled between the contracting parties. OTC derivatives differ from listed derivatives in several ways. First, although OTC transactions involve some standardization of terms, the presumption is that contracting parties are free to negotiate terms that fit their individual risk preferences. Second, instead of executing trades through an exchange, contracting parties execute transactions with dealers, who in turn trade with each other. Third, booking of transactions between contracting parties means that OTC derivatives involve direct exposures between the parties. These exposures lead to counterparty credit risk, which must be managed by the parties.

A third category, which has been increasing in importance since the global financial crisis, is *cleared OTC derivatives*, which are something of “hybrids” between ETDs and OTC derivatives and that involve the trading of standardized transactions that are privately negotiated but cleared through a CCP. Clearing transactions through a CCP means that dealers do not have direct counterparty credit exposure to each other but to the clearinghouse. Standardization need not be as extensive as in the listed derivatives markets, but a relatively high degree of standardization is necessary to facilitate clearing and risk management by the CCP.

The table below shows some of the features and characteristics of exchange traded and over-the-counter markets.

Table 1- Exchange Traded Derivatives versus Over-the-Counter Markets

Feature/Characteristic	ETD Markets	OTC Markets
Contracts/Instruments	Highly standardized	Largely customized to client requirements
Trades	High volume/frequency Lower value per trade	Low volume/high value
Liquidity	High	Low
Counterparty Risk	Mitigated through institutional risk management systems Born by CCP	Concentrated and sometimes long-term Born by parties to trades (except

Feature/Characteristic	ETD Markets	OTC Markets
		for CCP-cleared trades)
Transparency	High – pricing reported by exchange & widely disseminated	Low – pricing typically only reported to regulator, if at all
Price Discovery	Effective – due to high levels of liquidity and pre- and post-trade transparency	Ineffective – due to low levels of liquidity and transparency
Regulation of Participants	Intermediaries and participants highly regulated & supervised through authorization & certification including capital adequacy, fit & proper tests & suitability requirements	Varies widely – dealers may be authorized and regulated

1.2 Typical Instruments

Derivative instruments fall into two broad categories, namely, forward-based instruments and options. *Forward-based* instruments have symmetrical rights and obligations between the parties and have the effect of locking in a price or rate of a transaction (or exchange of value) that will take place on an agreed future date.

1.2.1 Forward-based Instruments

Forward (traded OTC) and futures (traded on-exchange) contracts allow parties to agree to the terms of a transaction (or exchange of value) that will take place at a future date. An example is a currency forward in which parties might agree today to exchange USD 1 million for BDT 80 million 60 days from today. Simply stated, futures contracts are standardized forwards that are traded on an exchange.

Swaps are OTC agreements to exchange cash flows at regular intervals over an agreed period according to terms agreed today; in effect, a swap is a sequence of forwards. A bank and its client might agree, for example, that over the next five years, the client will pay the bank a fixed rate of 5% on a “notional” BDT 100 million loan, while the bank will pay the client the three-month BIBOR rate on the same amount ... the client thus “swaps” a variable rate payment for a fixed rate one, which may better suit its purposes.

1.2.2 Options

Options are derivatives contracts that have price behavior that is nonlinear due to the asymmetrical nature of the rights and duties conveyed to the buyer (i.e. “holder”) and the seller (i.e. “writer”) of the contract. The pricing (i.e. “premiums”) of options is somewhat complex because of the number of variables involved, which include: the time

remaining to expiration, interest rates, volatility, and, of course, the current price of the underlying instrument, right or interest.

1.3 Typical Motivations of Derivatives Traders

Derivatives transactions are often classified according to the motivations and objectives of the transacting parties.

1.3.1 Hedging as a Primary Objective

One objective is hedging, which involves the transfer of an unwanted risk to another party in return for a “premium”. For example, a garment manufacturer/exporter might want to lock-in an exchange rate (i.e. the cost or US Dollars) for an anticipated export/sale transaction, or the cost of its raw materials (e.g. cotton) for an anticipated purchase transaction rather than face the risk of changes in these prices (e.g. the exchange rate, or the price of a bail of cotton fabric in the example above). A perfect hedge means that the hedger will be compensated through price movements in the hedge instrument (i.e. derivative contract) in the exact but opposite amounts for which the price of the object of the hedge fluctuates. This gain or loss is designed to “neutralize” fluctuations in the price of the object of the hedge (i.e. the foreign exchange rate or the price of cotton fabric in the referenced case). Thus, hedgers trade away price risk (i.e. lock-in a price), in exchange for the cost of the hedge (i.e. the premium).

1.3.2 Speculating as a Primary Objective

A second objective is speculation, which involves taking on risk from another party in order to profit from price changes. In the example above of the “cotton hedge”, the party taking on the opposite side of the transaction might be a speculator hoping to profit if the price of cotton increases. By acting as a *source of liquidity* to potential hedgers, speculators are a *vital and necessary* part of a derivatives market.

1.3.3 Dealing as a Primary Objective

A third objective is dealing, or market making, in which the dealer/market maker serves as an intermediary to facilitate the transfer of risk between hedgers and speculators, earning a spread between the two. Dealers may be considered hedgers because, upon taking on a risk from one customer, a dealer will generally hedge the risk with another customer or in the underlying markets. While market makers generally maintain hedged portfolios of transactions (i.e. “books”), they may also engage in speculation in order to *provide liquidity* to the market. For example, if a client wishes to establish a hedge position with a dealer but the dealer cannot immediately find an offsetting transaction, the dealer might enter into the transaction, in effect establishing a speculative (open) position on the unhedged portion of the trade.

The table below outlines some of the strategies employed by “users” of derivatives to achieve their primary objectives.

Table 2 - Typical strategies

Strategy	Description
Hedgers	Purpose: To hedge a natural underlying risk
	Examples: <ul style="list-style-type: none"> • Firms impacted by fluctuations of interest rates, such as mortgage holders, to hedge their prepayment or extension risks • Natural gas users for price changes due to geopolitical or international risks – typically by buying puts and selling calls • Interest rate swap users to protect swaptions, rate locks or other corporate deals • Commodity traders, including farmers or the Exploration & Production (E&P) producers for weather and agricultural risks
Investors	Purpose: To manage market risks of a portfolio
	Examples: <ul style="list-style-type: none"> • Long only firms managing duration risks of fixed income portfolios while still keeping credit or spread risks • Eurodollar bank traders wanting to trade the option and underlying future for capital efficiency reasons • International hedge fund managers looking to add or reduce a specific part of market risk to their portfolio
Directional	Purpose: To profit from a specific view of the market
	Examples: <ul style="list-style-type: none"> • Hedge fund portfolio managers making a call on a sector, but wanting to limit downside risks • Options traders wanting to expose a view on vega and/or gamma
Arbitrageurs	Purpose: To profit from price discrepancies
	Examples: <ul style="list-style-type: none"> • Trading companies that specialize in automated market-making and risk taking • Prop trading firms entering into transactions in two or more markets

1.4 Market Infrastructure: The Central Counterparty (CCP) – a vital component

Current best practice - crystallized in the wake of the global financial crisis – is for derivatives trading to be cleared through a clearinghouse that serves in the capacity of a central counterparty (CCP). A CCP performs three functions.

- First, by means of “novation” or an equivalent legal process (described above) at the clearing participant level, the CCP acts as buyer to every seller and seller to every buyer for derivatives transactions submitted for clearing by its members.
- Second, a CCP acts as “guarantor” by assuming the credit risk of all cleared transactions, and
- Third, a CCP provides multilateral “netting” of transactions.

Only CCP “clearing member/participants” (member firms) book (i.e., clear) trades directly through the CCP. Nonmember firms (or non-clearing participants) must access the clearinghouse through the intermediation of a clearing member/participant. By

their nature, CCPs (in the absence of the failure of a clearing member/participant) take on no market risk. This is to say that for every transaction with a positive value, there must be an equal and offsetting transaction with a negative value. CCPs around the globe clear many types of financial transactions, including equities (stocks), fixed-income securities, and derivatives - both exchange-traded ones and those traded over-the-counter (OTC).

2 Benchmarking - Emergence of Exchange-Traded Derivative Markets

The following BIS chart presents an overview of the recent growth of both OTC and exchange traded derivatives (ETD) in emerging markets although as is evident the volumes are small in comparison with developed markets.

The worldwide use of exchange traded derivatives is depicted in the charts attached at Annex 1 - International Benchmarking showing the quarterly activity by market and product type and the table below. As can be observed from these charts and the tables above and below, emerging markets currently account for a very small share of the \$600 trillion global derivatives market - barely one-half of one percent as of 2010. Notwithstanding, countries in Asia - like India and Korea - are beginning to experience significant daily turnover. Countries like Pakistan and Sri Lanka have not reported any significant derivatives trading activity although we know that some limited activity is taking place.

As seen in the table below and in the tables and charts included in Annex 1, emerging market derivatives activity has been most prominent in *foreign exchange* forwards and swaps, followed by *interest rate* forwards and swaps and then *commodity* hedging. Structured products (securitizations) and equity-linked derivatives play a small role in emerging market hedging at present.

Table 3 - Notional Value* of OTC Derivatives Transactions by Type (US\$ million, 2010)

	Total Amounts Outstanding	Foreign Exchange Contracts	Interest Rate Product Contracts	Commodity Contracts	Structured Products	Equity-Linked Contracts
Global OTC Market	\$601,046	\$64,698	\$465,260	\$2,922	n.a.	\$5,635
Emerging Markets	\$3,588	\$1,480	\$1,049	\$911	\$76	\$69
Daily turnover (US\$ billion)						
India	\$30.9	\$27.4	\$3.5	n.a.	n.a.	n.a.
Korea	\$54.5	\$43.8	\$10.7	n.a.	n.a.	n.a.
Malaysia	\$8.3	\$7.3	\$1.0	n.a.	n.a.	n.a.
Thailand	\$7.5	\$7.4	\$.07	n.a.	n.a.	n.a.

Source: IOSCO, *OTC Markets and Derivatives Trading in Emerging Markets*, July, 2010 and Bank for International Settlements, *OTC Derivatives Market Activity, First Half 2011*. *Notional value is the gross nominal value of all contracts.

3 The Current Situation in Bangladesh

Exchange traded derivatives do not exist in Bangladesh. The full extent of OTC markets (such that may exist) is largely unknown..

3.1 Current Approaches to Managing Risk

In this section we identify a number of financial risks that that may lend themselves well to being managed through the use of derivatives. Our focus is on derivatives contracts based on financial instruments (i.e. financial derivatives). While we acknowledge the existence of other risks that could be managed through the use of derivative instruments based on commodities, we do not address these risks here, as there are no organized spot/cash markets of any relevance for any commodities in Bangladesh that could serve as underlying instruments for commodities derivatives, and the development of active and liquid organized markets for commodities is not likely to occur in the foreseeable future due to a number of structural factors that are not likely to be resolved any time soon. These include the structure of the agricultural sector (i.e. dominated by "smallholder" subsistence farmers), the current state of infrastructure (i.e. road, rail and other transportation, bonded warehouse facilities, product standards etc.). As it is unlikely that these normal preconditions for the development of spot commodities markets would be available in the foreseeable future, we would consider addressing commodities derivatives at this stage to be too early in the development cycle for the capital markets.

3.1.1 Interest Rate Risk

To address their exposure to interest rate risk (a risk especially well-suited to being addressed by derivatives), commercial banks and other financial institutions in Bangladesh hedge this exposure by adjusting the "duration" of their assets and liabilities. This "balance sheet hedging" is accomplished by various initiatives to lengthen the tenor of deposits and shorten the maturity of the lending portfolio. In addition, commercial banks in Bangladesh usually reserve the right to "renegotiate" interest rates on loans on an annual basis, effectively limiting exposure to interest rate risk on that segment of the balance sheet to a one-year horizon. Fixed rate loans for extended tenors are rare in Bangladesh.

The constraints of the above described "interest rate risk management" strategy stem from the fact that it tends to limit the range of products and services available to bank customers. Commercial, industrial, and retail borrowers generally do not have access to long term lending instruments that could better address their credit requirements, match their "risk profile", and contribute to their long-term stability and growth. Retail

consumers generally do not access to long term credit products better suited for the purchase of residential properties, and so only those (high-income) households who are able to save sufficient down-payments and make high recurring payments for short term loans can afford to purchase homes. This inherent inefficiency has implications for economic growth – both in terms of its rate and in terms of its equity – i.e. the broad and balanced distribution of its effects across the entire economy/society.

Interest rate risk management is one of the areas that are best suited to being addressed by interest rate derivatives - as may be evident from the size of this segment of the global derivatives market. The above inefficiencies – and others – can be addressed through interest rate derivatives that provide banks with the tools that would enable them to manage the risks inherent in longer term lending so they can meet the latent demand for longer term lending products while controlling their own level of exposure to interest rate risk.

3.1.2 Foreign Exchange Risk

Managing the risk of exposure to fluctuations in foreign exchange rates is another area in which there are ample opportunities for derivatives to play a central role. We are informed by Bangladesh Foreign Exchange Dealers' Association (BAFEDA) that there is reasonably active market among banks in dollar/taka foreign exchange spot and forward transactions. These are usually overnight contracts but we are informed that they can extend to 60 days. The trading is done by telephone with trade confirmations followed by SWIFT.¹ While the degree of openness of the capital account is a key determinant of the success of foreign exchange derivatives, it would appear that one of the key prerequisite requirements (i.e. the existence of a large and sustained demand for the instrument) is most likely to be met.

3.2 Considerations for Introducing Derivatives

This section briefly discusses some of the issues financial sector policymakers in Bangladesh will need to address as they consider the introduction of derivatives.

3.2.1 Market Structure

The primary policy choices with respect to market structure are whether to support the development centralized or decentralized markets for derivatives. Policy makers will need to decide whether to support a market for exchange traded derivatives (ETD) or to encourage the development of derivatives through over-the counter (OTC) markets.

¹ At present the banks involved in these transactions use a “short form” of a standardized forward contract that requires that the terms of each contract be tailored. It would be better if BAFEDA members used internationally recognized standardized forward contracts or master swap agreements as developed by the International Swaps and Derivatives Association of the United States or the European International Capital Markets Association.

Some of the advantages and disadvantages of each approach were briefly reviewed in an earlier section of this paper (Section 1.1).

Our view is that the advantages of the centralized (ETD) approach outweigh its drawbacks, but this decision will need to be taken by policy makers in view of the broader policy framework for the development of the financial sector and the feedback and consensus of the community of stakeholders. We view the principal advantages of ETDs as greater liquidity, higher levels of transparency, and a greater level of control over access to the market to assure participation is limited to knowledgeable, well capitalized intermediaries and market/infrastructure operators that will be easier to monitor and manage. It is far more difficult to ensure that standards are met in OTC-based markets, and monitoring and supervising such markets is a far more challenging task that is likely to overwhelm the regulatory authority. Such a situation could provide fertile grounds for manipulative behavior and other misconduct that could easily spiral into a full-blown financial crisis, which could not only derail the effort to introduce derivatives but cause significant damage to the financial and real sectors. Such episodes have been observed in number of emerging market economies with disastrous consequences.

3.2.2 Products/Instruments – Range and Sequencing

After the decision on market structure (i.e. whether to introduce exchange traded derivatives or to support the development of OTC markets), a central issue needing to be addressed will be the range of instruments that should be authorized and the sequencing of their introduction.

An important principle in the development of derivatives markets, to which we would ascribe, is to offer a *limited number of simple instruments* in the early stages of market development so as to facilitate the attraction of demand, and to avoid fragmentation of liquidity. While this would need to be confirmed through a demand study, there is likely to be sufficient latent demand for at least three types of derivative instruments – those addressing interest rate, exchange rate and stock market risks.

Interest Rate Instruments – The demand for hedging of interest rate risk generally begins with holders of large positions in government securities – e.g. primary dealers and other banks and institutional investors that hold large portfolios of government securities. In the interest of concentrating liquidity in a few derivative instruments, a first step for Bangladesh might be to introduce a derivative contract based on a single tenor of government securities – e.g. the 91-day T-bill. The Primary Dealers' Association and Bangladesh Association of Foreign Exchange Dealers (BAFEDA) have indicated there may be a considerable latent demand for an interest rate derivative instrument in the

three-month segment of the yield curve that will cover interest rate risks in the overnight to six-month spectrum.

The absence of an interest rate derivative contract for each government security outstanding (i.e. 91, 182, and 364-days, and 5, 10, 15 and 20-years) will expose the market to “basis risk” when the yield curve shifts (as has been the case in Bangladesh in the last few years). That is, interest rates in the spot market may not rise or fall in the same proportion along the entire yield curve, rendering a derivative contract based on a the 91-day T-bill an imperfect hedge against the risks associated with longer tenor holdings (e.g. 5, 10, 15 and 20-year) of government securities.

A second step in developing the market for interest rate derivatives may then be to introduce a derivative contract based on a medium term government tenor - such as the 5-year government bond – to minimize basis risk for those users who are exposed to interest rate risk based on longer term holdings. These two instruments (i.e. based on the 91-day bill and 5-year bond) would probably satisfy the needs of a large segment of the market for some time. Concentrating liquidity in this manner would increase the chances of developing deep and liquid markets in these derivative instruments. Basis risk is a second-order of risk and markets, initially at least, can manage/tolerate this degree of risk.

We should note that generally, one of the first interest rate derivative instruments to emerge is a floating-for-fixed interest rate swap agreement.² Given that the interest rate on most commercial lending in Bangladesh is reset/renegotiated annually, there should be a pent-up demand by corporate borrowers to swap their adjustable rate payment streams for payment streams that are based on a fixed rate of interest. The swap spreads will initially be high reflecting the larger demand for fixed-for-floating, but this also means that commercial banks will predominately take the “short-side” of the swap agreement, which is the floating rate side. In the absence of the ability to sell short, an interbank market is likely to develop in which the banking system will swap this short risk amongst themselves to adjust their individual interest rate exposures, but eventually banks will need to be able to sell short government securities to better achieve “neutral” positions in their lending “book” – i.e. “delta neutrality”.

The price of a floating-for-fixed interest rate swap is quoted based on a domestic floating rate “index” (or “reference”) for the floating-rate side of the swap and the price of the benchmark government security of the same tenor for the fixed side of the swap. The Dhaka Inter-bank Offered Rate (DIBOR) appears to be the only likely candidate to serve as this “reference rate”. DIBOR was launched by the Bangladesh Bank and the Bangladesh Foreign Exchange Dealers Association (BAFEDA) on the 1st January, 2010.

² Globally, about 80% of all OTC interest rate derivatives are the floating-for-fixed interest rate swap. See: BIS, “*OTC derivatives market activity in the first half of 2011*”, November, 2011.

“DIBOR rates are quoted for four tenors extending up to 3 months. These rates are actively used in pricing various structured products including Interest Rate Swaps, Overnight Index Swaps and Cross Currency Swaps, etc.”³

Our investigations in 2012 revealed that the inter-bank market in Bangladesh (on which DIBOR is based) suffered from illiquidity and infrequency of transactions. Market participants and the financial press⁴ had reported that the interbank market was largely inactive as few banks were trading in this market, thus rendering DIBOR ineffective as an “index” (or “reference”) rate for interest rate swaps, as it is not likely to be accurately reflecting the cost of short term funds in the economy. In addition, as has been widely reported, and pointed out by several studies (including the one conducted by Cohn & Golden for the ADB), the secondary market for government securities also suffers from inactivity and illiquidity.

As a result, there is an absence of active, deep and liquid spot/cash markets for pricing either side (floating-rate and fixed-rate) of a swap agreement at the present time. As mentioned in this section and the section of this report addressing bond markets, however, recent developments may portend a change in this environment in the near to medium term. This will largely depend on follow-through in carrying out some of the recommendations already made by us under CMDP II, those made in the Cohn & Golden report, and those being considered under the present (CMDP III PPTA) project as reviewed/proposed in this report, and our forthcoming Final Report.

Thus, concentrating on the introduction of the above-mentioned interest rate instruments (i.e. based on the 91-day T-bill and the 5-year T-bond) in the initial stages may be a more productive strategy.

Foreign Exchange Instruments – It may be that a single foreign exchange derivative is needed to hedge the currency risk of Bangladesh's trading and capital flows. We are informed that in the existing FX forward market, 99% of all trades are currently done between the BDT/USD pair.⁵ While forward contracts may be meeting the needs of market participants for now, officials may want to consider the introduction of currency swaps in the medium to longer term to allow for the more internationally oriented commercial enterprises in Bangladesh to take advantage of differential borrowing rates.⁶ This could, as the market develops the capacity to absorb more sophisticated and complex instruments, be followed by the introduction of options on swaps (“swaptions”).

³ BAFEDA, *2010 Annual Report*, Section 6.1 Dhaka Inter-bank Offered Rate (DIBOR).

⁴ Bangladesh Business News, “Central Bank to Ask Commercial Banks to Participate in Dibor”, September 25, 2009, see: www.businessnews-bd.com; The Daily Star, “Dhaka Inter-Bank Offered Rate Launched”, January 7, 2010; and, The Financial Express, “First-Ever Dibor Transaction Held”, January 6, 2010.

⁵ BAFEDA, *Annual Report*, 31st December, 2010.

⁶ This would require coordination with initiatives to further liberalize/open the current and capital accounts.

Having said this, we reiterate the principle of keeping the variety of contracts to a minimum, in the initial stages, to concentrate liquidity. Moreover, the pricing of forwards, futures and currency swaps will (as is with the case for interest rate derivatives described above) require spot/cash markets that are able to produce a reliable reference rate based on a deep and liquid market for short-term lending and a reliable benchmark medium-term rate (e.g. 5-year T-bond) based on a deep and liquid secondary market for government securities, both of which are nascent at the present time.

Equity based Instruments – To hedge the risk of a portfolio of equity investments, an instrument based on a general stock index should be available. Institutional investors need the ability to hedge a portfolio of stocks that track fluctuations in the general market. As individual stocks rise and fall with the market, depending upon their correlation with the general market (beta for futures contracts or delta in options terminology), an instrument based on the general market will not always be a perfect hedge for individual stocks (i.e. the “basis risk” problem discussed above). However, the introduction of options on individual stocks should await the development of liquidity in the indexed instrument.

3.2.3 Financial Market Infrastructure

The market infrastructure requirements will largely stem from the policy decision concerning market structure. An exchange based market will require a derivatives exchange and central clearinghouse. The policy decisions will center on the following principal issues:

- Adequate levels of capitalization
- Governance and management structures
- Legal status
- Proper control of entry
- Appropriate systems
- Risk management systems, and
- Appropriate mechanisms for protection against default that could include a Settlement Guarantee Fund and/or Investor Protection Fund

3.2.4 The Primary Regulatory Authority

The policy choices are to have an existing regulatory authority to assume the role of regulating derivatives and derivative markets, or to designate a new agency take on this task. To a certain extent, this decision was made with the amendment to the Secu-

rities Ordinance in December 2012, effectively authorizing the BSEC to regulate derivative instruments, and by extension derivative markets. Policy makers could reaffirm this decision in a national policy for developing the derivative markets and this may be specifically addressed in a Derivative Act that sets forth the legal and regulatory framework for derivatives and derivatives market infrastructure.

3.3 Recent Developments

Our Final Report for CMDP II suggested that the actual introduction of derivatives in Bangladesh appeared to be patently premature. While we still maintain the position that the conditions that would support the actual introduction of are not likely to fully emerge for a number of years, we have, in our last mission, observed a number of developments - changes and trends - that may indicate a growing level of support, interest and commitment to taking the required steps to prepare an enabling environment in preparation for the introduction of derivatives.

Support appears to be developing both at the level of the regulator as well as among various groups that could potentially emerge as credible and suitable market operators. The reform program supported by CMDP II has stimulated a number of fundamental changes that could, potentially, see the capital markets put on a path to sustainable long term growth and development. Although it will take some time and considerable effort to fully realize such a benefit, the regulator has been fundamentally strengthened – its independence has been enhanced, its resources have been augmented, its authority has been extended and expanded, and its capacity to enforce has been improved.

These are all positive developments with respect to the prospects for derivatives, and a continuation of the above trends may hasten the arrival of the moment in which the prerequisite conditions (more fully described in our Final Report) for the introduction of derivatives are met.

3.3.1 Regulatory/Policy Developments

The BSEC, through an amendment of the Securities Ordinance of 1969, has clarified its regulatory perimeter with respect to derivatives. Through the introduction of Section 2 (cccc), it has established its authority to regulate derivatives.

The BSEC has also recently appointed two committees to prepare studies on matters related to the introduction of derivatives in Bangladesh. The first committee has been given the task of examining the feasibility of introducing commodities and derivatives exchanges. The “Commodities and Derivatives Exchange Committee” has issued its preliminary report after conducting a study tour to Malaysia and other jurisdictions. Members of this committee have recently completed a second study tour to India to

examine the legal, regulatory and operational aspects of derivatives and commodities markets in that country, and its final report is expected imminently.

The second committee has been assigned the task of examining the feasibility of introducing a central clearinghouse. Following the recent demutualization of the two exchanges, it has become evident to many stakeholders that the current fragmented structure of clearing and settlement may be impeding the development of the capital markets. The DSE and CSE have proposed a jointly own Clearinghouse be formed to take over the existing exchange settlement processes.

The appointment of the Committee to Study the Feasibility of Establishing a Central Clearinghouse is only the latest evidence of the desire to improve financial market infrastructure. This committee has also issued its preliminary report in which it supports the establishment of a broadly-subscribed, adequately capitalized, independent central clearinghouse with robust risk management systems and controlled access. While not specifically recommending central counterparty clearing and multilateral netting arrangements for this central clearinghouse, the study extols the virtues of both of these features that are critical prerequisites for the development of exchange traded derivatives.

3.3.2 The Emergence of Potential Market Operators (sponsoring groups)

During our last mission, we became aware of at least one group that has formed to investigate the feasibility of establishing a derivatives exchange. This group is led by a former CEO/Managing Director of the Chittagong Stock Exchange, and is tasked to develop a business plan within a time frame that would allow the establishment of a derivatives exchange fairly soon.

3.3.3 Developments in the Government Securities Markets

Recent developments in the government securities markets, supported by ADB technical assistance, may result in a deepening of the government securities market, and increase activity and improve liquidity in the secondary markets. Some of the supportive recommendations that are being considered by us under this TA could extend those gains. These developments could have positive implications for the prospects for an eventual introduction of interest rate derivatives.

4 Potential Opportunities for ADB Support

The confluence of the events and trends mentioned above may be an indication that the time may be right for the ADB to support some of the initial measures that would be needed, over the medium to long term, to develop an enabling environment for the eventual introduction of derivatives in Bangladesh.

4.1 Demand Study

We have presented our preliminary findings with respect to the types of instruments that may be considered and on sequencing the introduction of these instruments in Section 3.2.2 above. Such decisions, however, should be supported by a demand study that would carefully examine and seek to quantify the potential demand for the instruments discussed in this paper and others. Such a demand study could be done as a separate exercise, as a precursor to, or in conjunction with, the development of a Derivatives White/Policy Paper (discussed below).

4.2 White/Policy Paper

The development of derivatives and derivatives markets will require the sustained collaboration of a large number of actors over a long time frame. Work will need to be done on a number of fronts to include development of the legal and regulatory frameworks, tax policies, the adoption of accounting standards and related guidance, the development of self-regulatory organizations, standard contracts and conventions, etc.

Developing a policy framework that establishes the basic principles on which derivatives and associated markets and infrastructure will be developed and identifies the principal actors and their roles and responsibilities in this regard would considerably facilitate an orderly principles-based approach to the development of derivatives and associated markets. Such an effort would require the participation of all of the principal policy makers and stakeholders including the Ministry of Finance, Bangladesh Bank, the BSEC, the tax authority, and the various industry and professional associations such as the associations of banks, primary dealers, brokers-dealers, finance companies, foreign exchange dealers, as well as ICAB and ICMAB, and others. The various stakeholders would then be able to take their cues from this "central" policy paper in developing their own plans to facilitate the introduction of derivatives over the time frame envisioned in the accompanying road map.

4.3 BSEC Strategic Plans

The BSEC is likely to be playing a central role in the development of the derivatives markets. It will need to develop and adopt strategic plans for the different elements of the derivatives initiative. These strategic plans can be approached piecemeal or as a single effort. The following elements should be included in BSEC overall strategic plan for the development of derivatives and associated markets:

A strategic plan for putting in place the requisite "soft" infrastructure to include the legal, regulatory, and policy frameworks – this will include a Derivatives Act – setting forth the following:

- Regulations for authorization and oversight of the derivatives market (i.e. the derivatives exchange);
- Regulations for licensing/authorizing and supervising market intermediaries;
- Enabling legislation for the Central Clearinghouse
- Legislation enabling the process of “novation” (may be included in the Derivatives Act.) and clarifying the treatment, under bankruptcy laws, of assets pledged by market intermediaries as collateral with either the derivatives exchange and/or the clearinghouse.
- Regulations for borrowing and lending securities (BLS)
- Regulations for short selling

A strategic plan for engaging with private sector stakeholders, to inform and educate current and potential stakeholders on the benefits and risks of derivatives to include the following target groups:

- Industry professionals - A program developed in collaboration with industry associations (e.g. BAFEDA, Bangladesh Primary Dealers' Association, the banking industry association, etc.) to inform and educate financial sector professionals (e.g. banks, merchant banks, broker-dealers, finance companies, foreign exchange dealers, etc.) on the opportunities and risks involved in participating in the derivatives markets;
- The tax authorities - An awareness-raising program for the tax authority on the benefits and risks of derivatives, and of the need for adherence to principle of “tax neutrality” for the treatment of income and loss streams generated as a result of heading activities;
- An awareness raising program for the accounting and auditing profession on standard contracts and conventions for derivatives contracts and the need to adopt appropriate standards and provide guidance to members in preparation for the introduction of derivatives.
- A program for commercial enterprises and the business community informing them about the significant advantages and potential drawbacks of derivatives to demonstrate the potentially significant impact they can have on improving efficiencies in in the company sector.

4.4 Development of a Sustainable Central Counter Party (CCP) to Support a Derivatives Market

The next report on CMDP III will include a roadmap towards the establishment of a CCP in Bangladesh, which itself will need to be preceded by enhancing the existing cash equities markets clearing and settlement that is currently undertaken by the DSE and CSE. This roadmap will address the following:

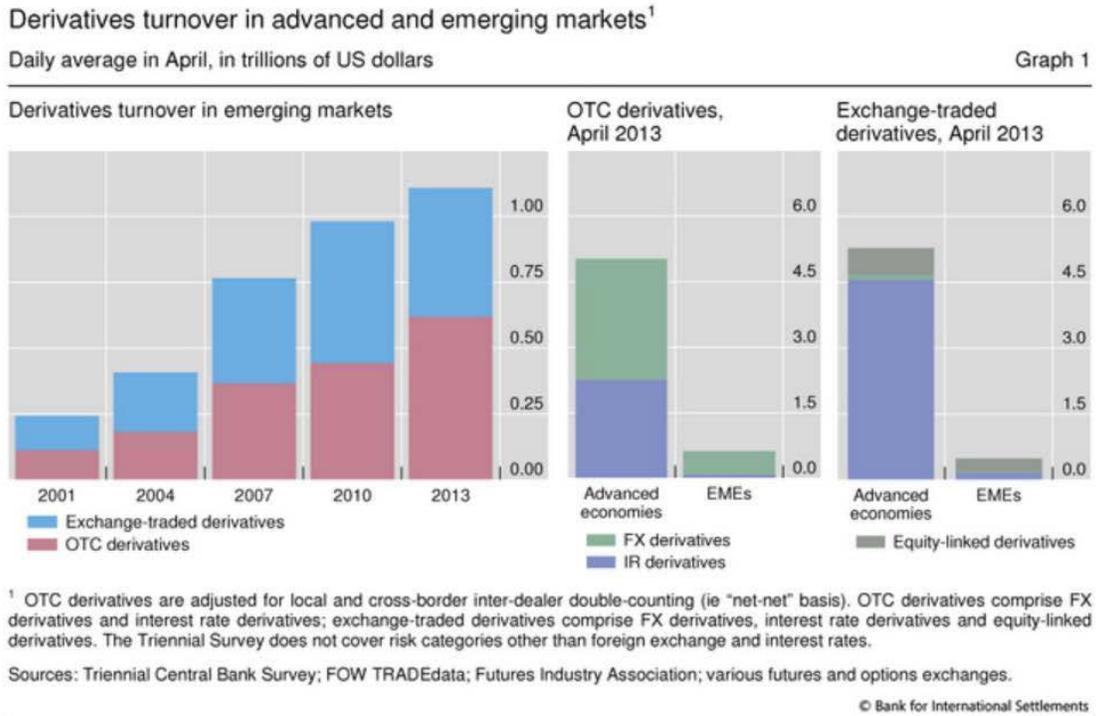
Enhancing existing equity cash market clearing and settlement

- What the risk management arrangements would need to look like;
- What the legal/regulatory requirements would need to be including any required legislation;
- What the ownership, governance and management structures should be developed;
- What functionality is required to meet IOSCO/CPSS standards for securities clearing and settlement; and
- Likely Clearinghouse participant arrangements will be required and the conditions of participation.

Enhancement to a full CCP to support a derivative's market

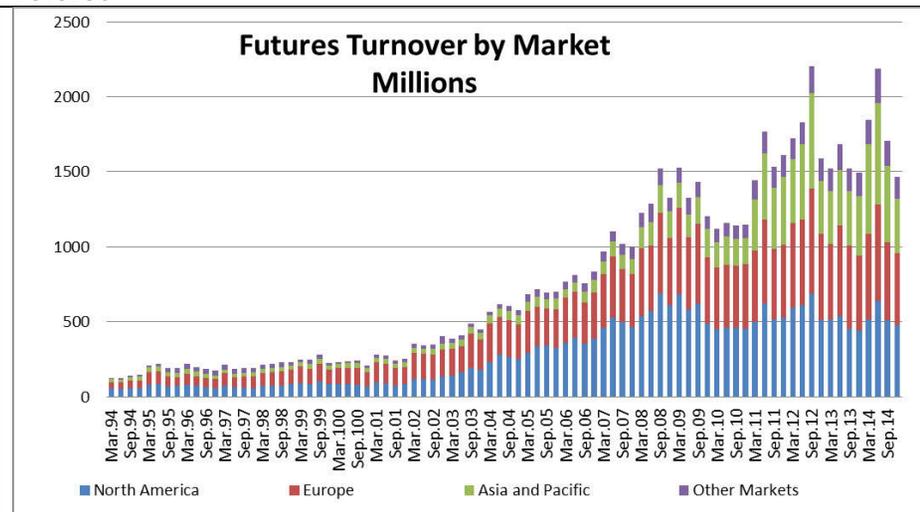
The roadmap will set out the conditions precedent required to promote the enhanced clearinghouse to a full CCP service in Bangladesh, including what will be necessary to meet IOSCO/CPSS principles for significantly important financial market infrastructure (PFMI).

Annex 1: International Benchmarking

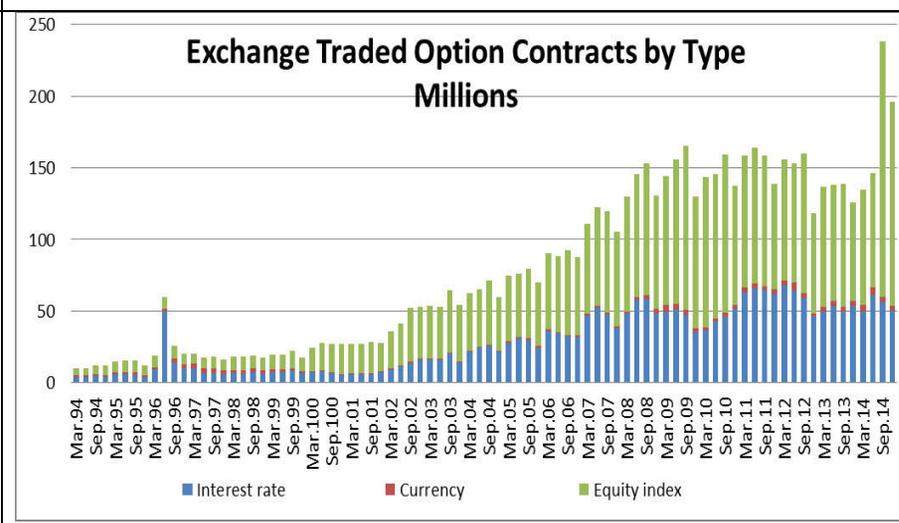
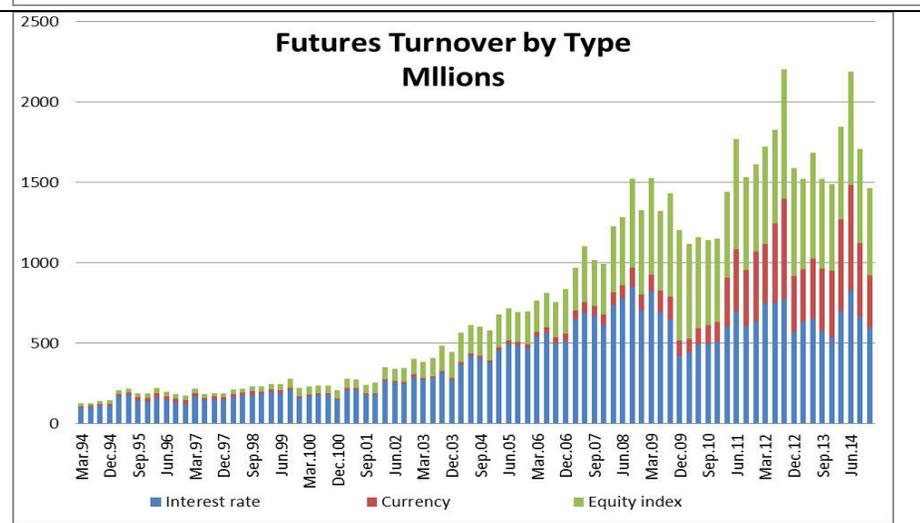


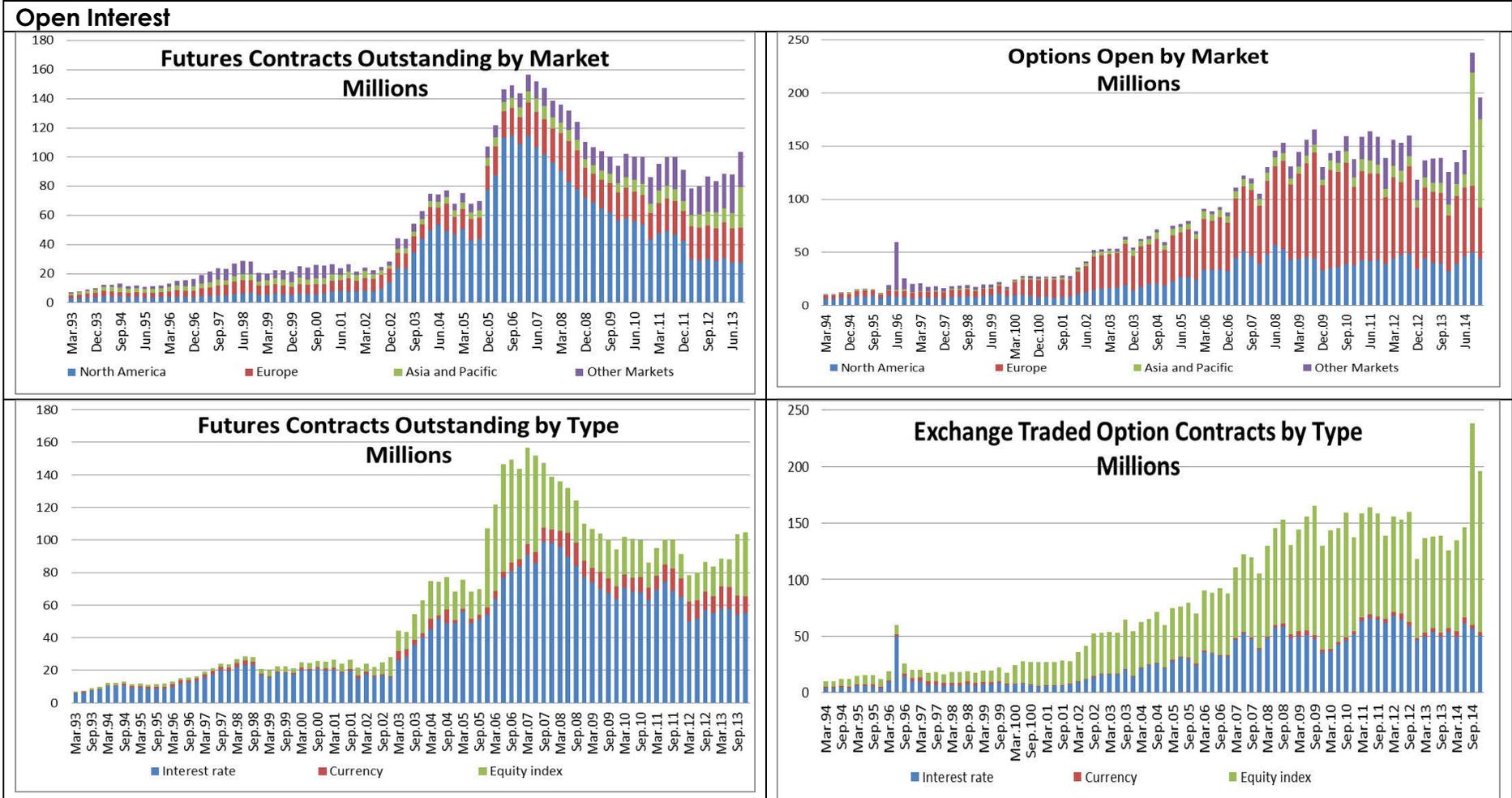
Turnover

Futures



Options





The BIS statistics do not cover equity products like exchange traded stock options and single stock futures. International Options Market Association (IOMA) data, published via the World Exchanges Federation, gives a more complete picture of exchange volumes for index products and single stock futures and options:

Index Futures	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Chicago Mercantile Exchange Group	306,058,671	379,748,159	470,180,198	641,551,177	882,432,628	703,072,175	695,147,655	735,845,814	588,494,089	572,902,335
Deutsche Bourse	161,700,235	184,494,565	270,134,951	400,538,510	511,748,879	395,243,697	436,273,618	486,325,501	383,583,126	327,431,218
Japan Exchange Group - Osaka	24,583,283	18,070,352	31,661,331	79,291,064	131,028,334	130,107,633	145,565,512	137,199,290	149,999,140	264,833,731
Moscow Exchange	-	-	-	-	-	-	-	-	322,870,350	213,237,983
ChiX Financial Futures Exchange	-	-	-	-	-	-	45,873,295	50,411,830	93,253,433	193,220,516
National Stock Exchange India	23,354,782	47,375,214	70,286,258	138,794,235	202,390,223	195,759,414	156,351,505	155,713,851	112,292,325	101,749,706
Singapore Exchange	16,428,731	21,735,080	31,200,243	40,364,696	60,212,079	52,140,365	59,230,325	68,831,646	74,021,187	99,526,505
NYSE Euronext (Europe)	52,732,215	56,092,515	72,135,006	91,813,789	106,099,614	92,867,375	94,268,808	97,223,103	84,002,370	82,669,154
Hong Kong Exchanges	11,742,376	13,393,886	19,747,246	32,339,682	44,436,944	43,201,921	42,753,763	50,229,356	46,383,244	50,608,221
Korea Exchange	55,608,856	43,613,540	46,696,151	47,066,930	66,436,912	83,117,062	86,762,976	87,274,461	62,430,640	49,970,933
CBOE Futures Exchange	-	-	-	-	-	1,155,969	4,402,616	12,044,512	23,892,413	40,193,447
TAIFEX	13,534,066	10,105,095	13,930,545	16,751,244	31,784,280	41,426,429	41,728,751	53,795,012	43,035,923	37,873,740
NASDAQ OMX Nordic Exchange	-	20,207,997	24,374,769	31,600,899	39,304,636	33,694,286	32,424,236	37,462,177	32,637,550	30,898,519
ICE Futures US	-	-	860,539	424,021	16,860,802	39,148,752	40,150,492	44,260,972	33,590,322	29,484,367
Japan Exchange Group - Tokyo	10,306,359	12,786,102	14,907,723	16,578,731	29,088,823	16,287,710	15,900,256	14,693,059	17,538,028	26,081,610
BM&FBOVESPA	6,759,469	6,065,361	16,827,755	26,564,366	-	-	18,039,345	21,650,138	22,328,572	20,443,962
Johannesburg SE	9,444,204	10,663,761	15,523,825	19,002,289	19,316,211	16,737,684	16,621,801	18,242,398	15,751,752	16,452,051
ASX SFE Derivatives Trading	4,622,139	5,604,726	6,541,632	8,412,807	10,174,823	9,413,157	9,936,165	11,969,393	9,819,551	9,994,096
BME Spanish Exchanges	4,474,114	5,050,616	6,568,657	11,300,997	10,575,717	8,585,281	9,860,262	8,380,865	7,169,833	7,565,969
Thailand Futures Exchange	-	-	-	1,228,238	2,099,098	2,522,465	2,471,302	4,316,430	4,134,746	5,688,404
Bourse de Montraeal	1,906,038	2,237,955	3,064,695	3,885,872	4,575,352	4,157,917	4,070,604	4,228,938	3,960,064	4,089,275
Oslo Bours	677,513	562,591	2,429,235	4,668,881	8,945,538	8,920,753	8,016,450	6,867,588	5,017,556	3,505,681
Bursa Malaysia Derivatives	1,088,419	1,111,575	1,628,043	3,157,341	2,920,728	1,997,975	1,994,907	2,482,314	2,132,330	2,678,309
Athens Exchange	2,922,919	2,512,957	2,634,145	2,736,718	2,832,157	2,371,733	2,965,284	2,484,813	2,041,250	2,324,227
BSE India	32,859	-	526,708	5,329,847	2,308,659	1,778	5,035	2,474,882	8,972,313	2,114,318
Mexican Exchange	348,835	410,565	620,557	951,955	1,085,663	1,130,528	1,321,686	1,231,048	1,060,760	952,165
Borsa Istanbul	-	-	-	-	-	-	-	-	48,765,770	850,876
Budapest SE	361,412	529,563	1,879,064	3,950,953	3,603,367	2,670,898	3,635,407	1,881,620	799,939	402,264
Wiener Bourse	78,558	104,677	154,521	143,068	238,851	267,064	331,234	342,162	380,394	358,558
ASX Derivatives Trading	-	-	-	238,823	309,499	396,723	370,800	270,236	258,989	257,098
Tel Aviv SE	8,304	13,460	32,474	19,802	29,600	43,467	21,599	31,596	67,746	63,590

Index Options	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
National Stock Exchange India	2,812,109	10,140,240	18,702,248	52,707,150	150,916,778	321,265,217	529,773,463	870,923,298	819,528,329	930,053,758
Korea Exchange	2,521,557,274	2,535,201,690	2,414,422,955	2,708,085,729	2,766,474,406	2,920,990,655	3,525,898,562	3,671,662,258	1,575,394,249	580,460,364
Chicago Board Options Exchange	124,946,505	192,536,695	284,056,441	245,805,629	259,496,193	222,781,717	270,006,239	320,393,391	304,351,269	372,668,403
Deutsche Bourse	117,114,860	149,338,291	217,232,549	353,038,706	514,894,678	402,256,322	368,838,114	468,383,997	382,644,407	317,411,074
BSE India	-	100	2	781	631	472	4,804	392,508	234,568,615	250,340,019
TAIFEX	43,824,511	81,533,102	99,507,934	96,863,107	98,122,308	76,177,097	97,116,723	126,390,420	108,773,711	109,671,774
Chicago Mercantile Exchange Group	6,451,612	15,106,187	27,515,449	40,876,208	44,210,472	31,808,915	40,297,218	58,850,339	59,141,790	91,006,693
Japan Exchange Group - Osaka	16,561,365	24,894,925	28,231,169	29,181,598	32,126,060	34,986,005	44,094,809	45,192,519	48,763,723	57,269,727
Tel Aviv SE	37,341,148	62,997,585	75,542,933	94,607,681	80,624,812	62,115,722	70,457,066	87,800,046	57,423,608	48,316,446
NYSE Euronext (Europe)	99,607,852	69,146,718	50,272,812	61,814,764	66,932,085	63,388,032	57,433,095	51,286,053	38,584,584	41,471,384
Moscow Exchange	-	-	-	-	-	-	-	-	33,957,361	30,943,045
NASDAQ OMX Nordic Exchange	-	12,228,816	13,613,471	19,715,226	19,653,395	14,153,606	13,759,381	12,485,788	12,638,806	21,758,989
Hong Kong Exchanges	2,133,708	3,367,228	4,915,263	9,279,120	5,592,128	7,615,125	11,922,207	15,426,409	16,787,385	17,826,035
Singapore Exchange	249,388	157,742	387,673	413,714	233,930	114,671	632,983	2,091,076	4,728,108	10,501,431
ASX Derivatives Trading	-	-	-	1,797,754	2,819,582	3,486,914	5,274,603	10,321,625	11,501,735	9,224,326
NYSE Euronext (US)	336,544	650,186	10,050,680	14,100,521	7,428,677	3,483,301	2,952,710	2,065,293	4,843,556	8,300,737
BME Spanish Exchanges	294,750	440,741	551,058	5,670,773	8,286,224	4,357,260	3,072,418	2,198,967	4,206,058	5,172,426
International Securities Exchange	83,358	4,464,094	8,212,419	16,212,458	18,136,147	13,553,780	11,865,818	7,605,085	5,512,317	4,295,754
Johannesburg SE	11,268,763	11,604,800	11,801,032	15,771,727	14,608,165	10,326,359	5,325,232	4,610,236	4,225,710	4,152,734
NASDAQ OMX	-	-	-	-	5,612,962	3,765,371	3,336,186	5,464,805	8,191,913	2,496,241
BM&FBOVESPA	1,589,765	2,257,756	1,818,764	384,837	210,868	199,147	281,815	623,103	1,045,256	982,688
Oslo Bours	695,672	515,538	1,331,023	1,818,340	1,436,679	743,589	743,726	715,712	802,028	864,097
Bourse de Montreal	38,892	27,897	57,974	26,484	38,665	34,056	77,820	93,151	314,631	511,204
ASX SFE Derivatives Trading	518,511	675,370	646,627	564,156	436,869	319,735	382,378	423,390	441,838	388,450
Japan Exchange Group - Tokyo	17,643	20,004	18,354	19,555	62,045	52,523	120,040	21,342	22,683	386,231
Athens Exchange	941,387	700,094	670,583	629,359	443,940	383,564	610,076	328,390	223,416	194,455
Thailand Futures Exchange	-	-	-	8,646	45,684	95,504	107,317	107,993	54,057	65,409
ICE Futures US	-	-	159,209	111,431	213,501	165,116	211,635	158,299	67,776	65,132
Mexican Exchange	35,989	37,346	117,568	130,410	52,556	40,723	147,411	65,631	42,653	54,853
Wiener Bourse	35,463	37,037	25,400	36,314	26,134	18,840	33,593	28,332	27,452	14,876
Bursa Malaysia Derivatives	-	-	-	-	-	-	-	16	5,493	5,311

Single Stock Futures	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Deutsche Bourse	-	77,802	35,589,089	52,454,783	130,210,348	116,771,129	202,188,548	174,288,806	196,260,661	179,424,059
National Stock Exchange India	44,051,780	68,855,275	100,430,505	179,324,970	225,777,205	161,053,345	175,674,069	160,878,260	153,122,207	166,371,450
NYSE Euronext (Europe)	13,491,781	12,158,093	29,515,726	75,890,097	124,468,809	181,044,957	291,272,890	250,441,783	246,541,679	130,051,531
Korea Exchange	-	-	-	-	11,552,111	36,970,994	44,711,133	59,966,166	100,490,960	95,870,157
Johannesburg SE	8,922,123	24,486,773	69,663,332	265,040,263	431,221,851	88,866,925	78,756,323	50,769,051	28,892,202	26,288,569
BME Spanish Exchanges	12,054,799	18,809,689	21,120,621	21,294,315	46,237,747	44,586,779	19,684,108	27,578,789	21,220,876	14,929,475
Thailand Futures Exchange	-	-	-	-	3,838	145,758	969,353	1,578,091	2,168,037	8,415,967
Athens Exchange	917,778	1,424,516	2,476,487	3,096,557	3,713,266	5,037,065	4,701,785	7,553,643	13,046,535	6,666,972
ASX Derivatives Trading	-	-	-	706,656	971,261	777,732	543,676	3,460,934	5,407,123	6,117,166
TAIFEX	-	-	-	-	-	-	724,375	2,471,605	4,670,750	5,448,554
Oslo Bours	-	1,796,570	3,088,078	2,632,749	1,764,449	1,172,473	1,466,739	1,944,280	1,645,446	3,685,393
NASDAQ OMX Nordic Exchange	-	5,658,355	8,459,167	9,013,489	15,836,947	6,718,337	2,459,997	4,011,568	1,979,581	3,613,681
BSE India	5,322	-	6,124	717,120	2,981	6	1	163,222	170,421	1,638,505
Budapest SE	706,386	740,396	919,424	1,529,195	1,163,279	1,105,553	1,033,190	806,061	609,797	686,028
Hong Kong Exchanges	17,274	13,069	102,010	351,514	258,692	271,766	239,259	444,014	322,715	437,173
Colombia SE	-	-	-	-	-	-	94,654	32,563	53,961	112,753
Mexican Exchange	12,591	19,400	3,000	2	2,000	-	12,044	56,869	35,839	66,870
Borsa Istanbul	-	-	-	-	-	-	-	-	-	1,683
Wiener Bourse	7,862	23,748	12,371	8,760	6,981	6,053	4,895	4,430	215	16
Bourse de Montreal	-	-	-	-	-	-	-	-	-	-

Single Stock Options	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
BM&FBOVESPA	233,759,749	266,362,704	285,699,806	367,305,446	350,063,629	546,790,413	802,229,293	838,325,493	929,284,637	909,313,950
NASDAQ OMX	-	-	-	-	537,954,692	478,715,134	639,560,836	700,991,781	639,089,751	688,536,609
International Securities Exchange	360,769,161	442,387,776	583,749,099	806,556,539	989,525,443	946,693,771	470,680,991	431,111,381	457,082,239	638,157,319
NYSE Euronext (US)	195,402,074	193,086,271	383,580,965	562,121,492	392,282,359	444,747,330	592,443,006	634,144,955	594,616,836	584,404,703
Chicago Board Options Exchange	186,562,316	275,646,980	390,657,577	698,656,170	933,855,344	911,976,695	572,854,979	516,137,672	494,303,386	434,486,036
Deutsche Bourse	211,661,359	255,918,793	272,543,052	322,052,853	349,331,404	304,553,303	308,865,369	275,313,232	215,454,872	202,814,062
ASX Derivatives Trading	-	-	-	22,226,578	16,070,022	14,465,066	15,455,208	108,860,114	140,439,020	124,300,972
NYSE Euronext (Europe)	302,966,312	243,166,204	155,552,010	186,152,718	184,105,407	170,870,365	194,714,042	150,562,241	112,840,693	98,697,280
National Stock Exchange India	4,874,958	5,224,485	5,219,827	9,048,495	11,067,082	14,066,778	28,363,426	33,172,963	57,221,005	81,704,608
Hong Kong Exchanges	5,611,832	8,722,393	18,127,353	45,982,968	54,692,865	47,439,896	60,656,402	73,309,376	55,141,693	58,207,042
Buenos Aires SE	94,686,640	92,386,767	49,235,173	52,388,712	25,165,308	25,132,711	42,993,383	42,186,092	42,988,781	53,270,161
NASDAQ OMX Nordic Exchange	-	57,113,786	64,545,443	59,653,719	42,764,705	28,771,003	32,721,486	29,836,598	28,553,660	29,225,839
BME Spanish Exchanges	8,200,314	10,915,197	12,588,027	13,593,486	18,315,249	35,527,914	37,607,374	29,414,590	34,507,360	26,945,064
Bourse de Montraeal	8,590,035	10,032,237	12,260,403	13,422,456	15,650,651	17,291,023	19,665,934	28,078,546	24,200,766	21,335,465
Johannesburg SE	6,829,460	2,801,262	5,751,835	14,303,446	19,591,351	15,670,396	12,358,594	11,327,943	9,783,374	10,667,955
Moscow Exchange	-	-	-	-	-	-	-	-	5,865,454	5,799,006
Oslo Bours	2,921,189	3,325,368	5,781,666	4,843,980	3,976,223	2,549,140	3,504,368	4,467,077	3,361,910	3,730,905
Tel Aviv SE	-	-	-	-	-	267,614	977,947	817,532	480,262	1,104,247
Japan Exchange Group - Tokyo	174,482	201,798	190,876	145,449	88,256	662,813	834,820	596,045	414,227	1,088,933
BSE India	4,362	-	8	15	-	-	-	36,644	45,908	750,426
Mexican Exchange	4,290	135,931	448,120	78	585,037	345,718	618,790	446,549	477,525	701,376
Wiener Bourse	2,077,320	816,032	1,053,298	1,036,975	848,021	474,697	469,216	560,419	359,943	112,397
TAIFEX	410,026	1,018,917	1,089,158	1,299,858	872,880	8,240,390	70,272	130,558	113,134	78,638
Japan Exchange Group - Osaka	1,481,415	1,206,987	753,937	444,149	534,954	408,752	542,427	1,218,762	46,322	22,543
Athens Exchange	27,463	21,729	17,194	106,893	182,757	67,590	105,359	64,238	34,265	18,481

APPENDIX 8

DEVELOPING ENHANCED CLEARING

APPENDIX 8: DEVELOPING ENHANCED CLEARING

1	Background	1
1.1	Current Clearing and Settlement Mechanism	3
1.2	Current Clearing and Settlement Mechanisms	4
1.2.1	Risk in Current Clearing and Settlement Arrangements	4
1.2.2	Key Benefits of an Enhanced Equity Cash Market Clearing and Settlement Process	4
1.3	Demerit of Possible Increased Fees	5
2	Regulatory Framework for a National Clearing and Settlement Regime	5
3	Establishment of CLEARCO	6
3.1	Incorporation of CLEARCO	6
3.2	Ownership Structure	6
3.3	CLEARCO's Minimum Capital	7
3.4	Management of CLEARCO	7
3.5	Information Technology Systems	7
3.6	Linkages to CDBL Systems	7
4	TREC Participants in CLEARCO	7
4.1	TREC Risks that CLEARCO Needs to Cover	8
4.2	TREC Operational Requirements	8
4.3	TREC Commitments to CLEARCO	9
5	Settlement Guarantee Fund	9
5.1	Initial Level of Settlement Guarantee Fund as a Condition of Demutualization	10
5.2	Other Sources Funds for the Settlement Guarantee Fund	10
5.3	Actuarial Study to Design Optimum Level of Settlement Guarantee Fund	10
5.4	CLEARCO to be Member of RTGS and Treated as a Quasi-Bank for Settlement Purposes	11
6	Key Milestones for Development of Enhanced Cash Equity Clearing	11
7	Transition from Enhanced Clearing to a CCP Process	12
7.1	What is a CCP	12

7.2	Standard Features of a Central Clearing Corporation (CCP)	13
7.3	Key Differences Between “Enhanced Clearing and Settlement” and a CCP	14
7.4	Should a Derivative Market Have a Separate CCP?	15
8	Roadmap to a CCP Process.....	15
9	Recommendations on ADB Conditionality and Possible Technical Assistance	16
9.1	Potential 1 st Tranche Policy Actions:	16
9.2	Potential 2 nd Tranche Policy Actions	16
9.3	Technical Assistance	17
10	Conclusion.....	17

APPENDIX 8: DEVELOPING ENHANCED CLEARING

PART I Enhanced Cash Equities Clearing and Settlement

1 Background

The current stock exchange cash equity clearing and settlement process in Bangladesh provides considerable risk to the Dhaka and Chittagong Stock Exchanges (DSE, CSE) and may impact on the perceived stability of the Bangladesh capital market in times of market stress.

A business department in each exchange is responsible for overseeing the clearing process with settlement facilitated with links to the Central Depository of Bangladesh Limited (CDBL), and the current process carries considerable risk for the exchanges as there is a lack of capital adequacy at the participant level, as well as an inadequately funded settlement guarantee fund.

Should a participant fail to fund settlements or deliver the securities sold then the exchanges are tacitly looked at to settle the transactions but there is no certainty that the exchanges will have the capacity to settle the transactions.

Other issues and risks are:

- a) Duplication of clearing and settlement infrastructure at DSE and CSE;
- b) Lack of DVP for indirect market participants;
- c) The need for participants to provide cash and securities ahead of settlement date;
- d) Lack of 'straight through processing' (STP), leading to manual rekeying of orders and file transmission, and increasing operational risk; and
- e) The DSE and CSE in essence carry the default risk and the current Settlement Guarantee Fund may not be sufficient to cover defaults

The DSE and CSE recognize these risks and have signed a memorandum of understanding (MOU) setting out proposals to develop a new entity to formally take responsibility for the clearing and settlement function via a new clearing and settlement company (CLEARCO) jointly owned by the two exchanges.

DSE and CSE have demutualized and the clearing and settlement risk may inhibit the viability of the exchanges as potential listed entities. Further the two exchanges are desirous of developing new markets in Bangladesh such as financial and commodity

derivatives. Derivatives markets require the development of clearing and settlement mechanisms normally utilizing the use of a Central Counterparty (CCP) entity which novates the buyers' and sellers' contracts which enables the CCP to stand as guarantor to the settlement the derivative contracts.

Across Asia there are many variants of the CCP model of clearing and settlement deployed in markets. The Bank of International Settlements (BIS) and IOSCO's Committee on Payment and Settlement Systems (CPSS) provide guidelines to markets to ensure adequate mechanisms are deployed to minimize the risk to the market and protect against wider systemic risk. CCPs are increasingly viewed as Significant Market Infrastructure vehicles and increasingly Central Banks are taking a lead role in their oversight for this reason, particularly as they are expanded to facilitate the settlement of OTC activity such as interest rate and currency swaps.

The Bangladesh Securities and Exchange Commission (BSEC) in 2014 formed a committee to investigate and report on the development of a CCP for the Bangladesh market as part of the planned development of derivative markets. It has also recently had a committee formed to look at the level of ongoing risk based capital adequacy that licensed securities entities (including DSE and CSE participants) should maintain.

This paper posits that to facilitate a move towards the development of derivative products and to facilitate the development of a CCP, a first necessary step will be for the current DSE and CSE cash equity clearing and settlement to be enhanced by the development of an independent, well capitalized independent CLEARCO, which is appropriately capitalized, with access to an adequate settlement guarantee fund and which deploys modern risk management disciplines.

CLEARCO will have to be supported by market participants which have adequate risk based capital, are subject to risk based supervision and are monitored dynamically for their financial position based on their level of trading activity, particularly where they are providing margin finance. Complimentary action is also required to develop an adequate investor protection fund.

1.1 Current Clearing and Settlement Mechanism

Figure 1 – DSE Current Clearing and Settlement Flow

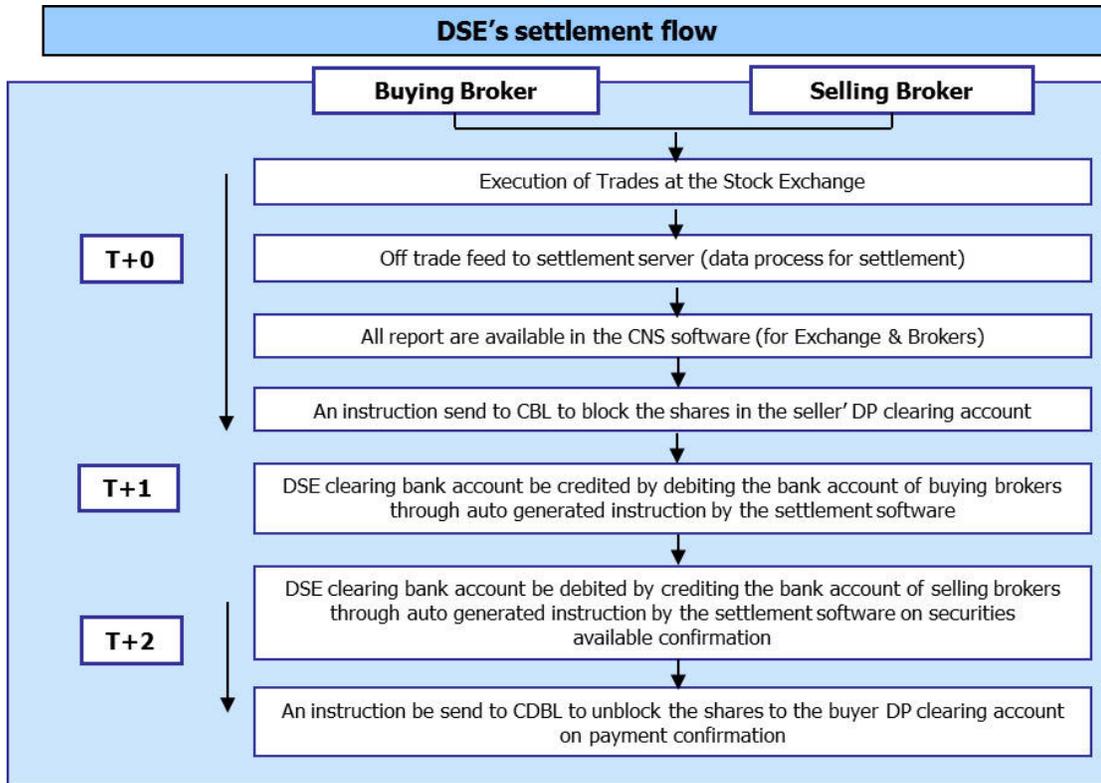
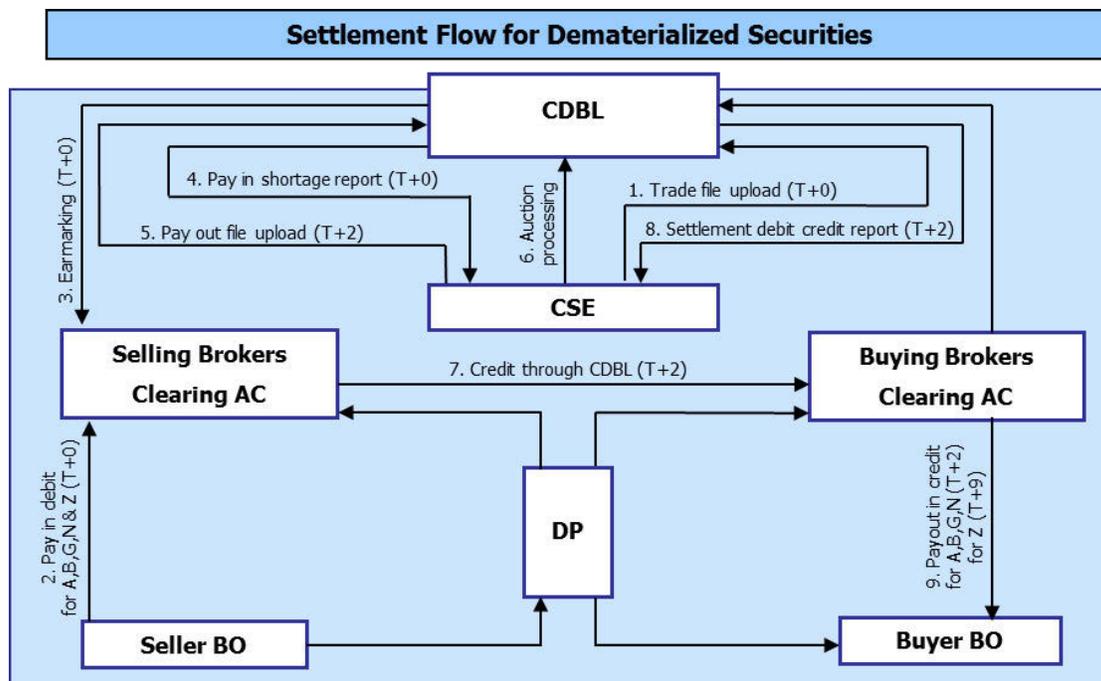


Figure 2 – CSE Current Clearing and Settlement Flow



Both DSE and CSE clearing and settlement flows are similar but slightly different and the development of CLEARCO will require the establishment of a National Clearing and Settlement System.

1.2 Current Clearing and Settlement Mechanisms

Both DSE and CSE have independent IT systems which have links to the CDBL utilizing so called DP clearing accounts. The process utilizes the following features:

- Settlement Banks utilizing pay and collect by direct debit and credit;
- Dematerialization with no physical receipt/issuance of instruments;
- Straight through processing without manual intervention
- Transfer between participants DP clearing accounts
- Reasonably robust IT infrastructure

1.2.1 Risk in Current Clearing and Settlement Arrangements

The two exchanges carry any default risk or operational risk emanating from the current process. Settlement Banks will fund any shortfall of a participant and the market will look to the two exchanges to make whole any participant shortfall. To date risks have been contained as volumes have been somewhat reduced after the market break in 2007/8.

In 2014 the two exchanges demutualized and became independent from the influence of the old broker member relationships with memberships replaced by Trading Right Entitlement Certificates (TREC).

The exchanges, as independent businesses with ambitions to list on their own markets need to be freed from the implicit risk of default by TRECs and investors protected by better risk management of the clearing and settlement process whilst the regulators and market require reduced risk of a systemic event which could easily occur under the current arrangements.

1.2.2 Key Benefits of an Enhanced Equity Cash Market Clearing and Settlement Process

- Both exchanges will be freed from settlement risk;
- Operational efficiencies will be derived from a national clearing and settlement system;
- Reduced operational costs for the exchanges;
- Improved capital adequacy required for TRECs; Only well capitalized TRECs will be able to be CLEARCO participants and other participants will have to make

arrangements with TREC participants who have sufficient capital to be approved as general Clearing participants who can clear other TREC participant transactions;

- Enhanced independent operational management and risk management by CLEARCO with oversight by both the BSEC and Central Bank of Bangladesh to BIS and IOSCO standards; and
- CLEARCO would be a “for profit” entity which would enhance the exchanges as listed entities.

1.3 Demerit of Possible Increased Fees

Whilst the new clearing and settlement process managed by a CLEARCO should provide a basis for enhanced confidence and increasing levels of activity in the market there is the possibility that initially fees for clearing and settlement may have to rise to cover the set-up of CLEARCO and the return on required increased capital adequacy of TRECs and their increased commitments to a settlement guarantee fund.

However, experience in other markets has been that the benefits of enhanced clearing have paved the way for the development of derivatives and vastly increased transaction levels.

2 Regulatory Framework for a National Clearing and Settlement Regime

The BSEC and the two exchanges need to develop a set of rules and regulations for the establishment and running of the National Clearing and Settlement regime for certain security instruments being careful to not impinge on the clearing and settlement of Government Debt and money market instruments which may need alternative arrangements at this time to the cash equities markets operated by the DSE and CSE.

The proposed regulations should cover the licensing requirements of the proposed CLEARCO with attention given to the following:

- a) Approval by BSEC of CLEARCO's Memorandum and Articles of Association and any proposed National Clearing and Settlement Rules to be drawn up by CLEARCO.
- b) Minimum Capital and ongoing capital requirements for CLEARCO itself;
- c) Approval of the Board of Directors including independent directors;
- d) Approval of Auditor;
- e) Approval of CEO;

- f) Approval of Corporate Governance arrangements including Risk and Audit Committees;
- g) Directions as to operation of the National Clearing and Settlement regime;
- h) Management and fiduciary oversight of the National Settlement Guarantee Fund;
- i) Minimum capital, governance, and operational requirements for TREC participants either as ordinary or as general clearing participants;
- j) Annual Report and ongoing reporting requirements of CLEARCO to BSEC;
- k) Approval of the investment policy for monies and investments held by the National Settlement Guarantee Fund;
- l) Default procedures and notification requirements for TREC clearing participants; and
- m) Any other oversight requirements that BSEC may deem appropriate to establish and provide for the ongoing operation of CLEARCO and/or the National Clearing and Settlement regime.

3 Establishment of CLEARCO

This section looks at the steps necessary to establish and provide for ongoing management and oversight of CLEARCO.

3.1 Incorporation of CLEARCO

The DSE has obtained name clearance from the Registrar of joint Stock Companies (RJSC) the names:

- Bangladesh Clearing and Settlement Company Limited; and
- Central Clearing and Settlement Company of Bangladesh Limited

One of these names or another has to be settled upon and a company then registered with an appropriate capital base as provided in the BSEC regulations covering the National Clearing and Settlement regime.

3.2 Ownership Structure

According to the MOU entered into by the two exchanges (21st August 2013), the proposed CLEARCO was to be held by DSE as to 67.5% and CSE as to 32.5%. This structure has to be approved by BSEC although as the investment in CLEARCO may

require significant additional capital as the market grows and particularly as it eventually becomes a CCP, possibly clearing and settling derivative markets, there may be a case to widen the ownership of CLEARCO to include CDBL and /or institutional investors. Internationally exchanges have tended to wholly own Clearing and Settlement subsidiaries.

3.3 CLEARCO's Minimum Capital

BSEC and the exchanges should employ an actuarial firm to study the Bangladesh market's turnovers and volatility to address the level of minimum capital required for CLEARCO. The same study could address the capital requirements for TREC clearing participants, the respective contributions to the Settlement Guarantee fund by investors and market infrastructure companies and alternative on-going sources of finance for the accumulation of funds for the guarantee fund. This will be further discussed below.

3.4 Management of CLEARCO

It is important that CLEARCO is run at arm's length and independently to the two exchanges to avoid conflict of interest and to preserve the ability to act as a self-regulatory entity if desired by the BSEC. The CEO should be approved for office by the BSEC and management should be sufficiently qualified and experienced to undertake the day to day operations.

3.5 Information Technology Systems

The system to be deployed should be approved by BSEC and tested to a high standard before actual implementation. The system should meet certain criteria laid down by the BSEC and have the capacity and cycle processing times within international standards. It should have ability to be rapidly scaled to cater for new products such as derivatives.

3.6 Linkages to CDBL Systems

The linkages to the CDBL depository and registry activities should be mandatory to BSEC specifications. This is necessary to ensure absolute finality of settlement on a delivery versus payment basis. These linkages will be mainly restricted to cash market activities as it is envisaged that most derivative transactions will be cash settled and not involve CDBL.

4 TREC Participants in CLEARCO

One of the primary reasons to form CLEARCO is to manage the risk posed by TREC participants which may financially fail to fulfil their obligations to settle transactions. This risk currently lies largely with the two exchanges and CLEARCO will be now be exposed to TREC participant failure via credit market and operational risks arising from the level

activity they undertake as well as exposure to the provision of margin finance by TREC holders and other risks within the TREC's business.

4.1 TREC Risks that CLEARCO Needs to Cover

The RBCA risks are currently being studied by BSEC which is looking to introduce a risk based capital adequacy regime for licensed entities including TRECs.

As CLEARCO has direct exposure to a TREC clearing participant it is envisaged that it will require it to:

- Maintain a minimum level of liquid capital as calculated under the BSEC proposed new RBCA regime either for an ordinary clearing participant or as a general clearing participant¹;
- Contribute a minimum sum of money to the Settlement guarantee fund based on the level of clearing participation;
- Contribute a further variable sum of money to the settlement guarantee fund based on its level of activity over a previous period, say six months; and
- Agree to be a member of the credit ring to replenish on a prorate basis the loss of guarantee funds due to fellow participant default.

Further the TREC will be subject to regular risk based supervision including financial audits by both BSEC and CLEARCO.

4.2 TREC Operational Requirements

In addition CLEARCO will require the TREC participant to meet certain operational, systems and management requirements to ensure its ongoing ability to meet the requirements of the Clearing and Settlement regime, including replenishment of the fund in case of a participant default. These requirements will cover:

- Sound qualified management
- Appropriate Systems
- High Standards of Governance, Compliance, Internal control and Risk Management
- Being a member of the credit ring to cover default in proportion to the activity undertaken

¹ General clearing participants can clear their own trades, client trades and other TREC holders business.

4.3 TREC Commitments to CLEARCO

The requirements for clearing participation may be as follows:

	Individual clearing Participant	General Clearing Participant
Administrative & Legal Requirements	<p>Letter of application</p> <p>Requisite documents (articles of association, financial statement, list of shares holders)</p> <p>Adequate separation of the task between the function of risk management, compliance, marketing & back office</p> <p>Agree to contribute to Guarantee Fund</p> <p>Agree to be one of credit ring members</p> <p>Applicants must have Risk Management Division</p>	<p>Letter of application</p> <p>Requisite documents (articles of association, financial statement, list of shares holders)</p> <p>Adequate separation of the task between the function of risk management, compliance, marketing & back office</p> <p>Agree to contribute to Guarantee Fund including collecting from its Trading Members</p> <p>Agree to be one of credit ring members</p> <p>Applicants must have Head of Risk Management Division</p>
IT Requirements	<p>Applicant sets up connections to all interested parties (CLEARCO CDBL, back office service provider)</p> <p>Banking online</p> <p>Applicant must have integrated front office & back office system</p> <p>Applicant agree to implement risk management system from CLEARCO</p>	<p>Applicant sets up connections to all interested parties (CLEARCO CDBL, back office service provider)</p> <p>Banking online</p> <p>Applicant must have integrated front office & back office system</p> <p>Applicant agree to implement risk management system from CLEARCO</p>
Possible Minimum Cash Collateral	BDT 0.5 billion+ BDT 0.5 Billion in Bank Guarantee	BDT 3 Billion or BDT 1.5 Billion + BDT 2 Billion in Bank Guarantee

5 Settlement Guarantee Fund

A key feature of the new Clearing and Settlement regime is the adequate funding of a Settlement Guarantee Fund. This was foreshadowed in the lead up to demutualization where the DSE and CSE committed to increase their contributions to their respective Guarantee funds. The fund will need to have sufficient initial funds and sources of funds from ongoing market activity. There was an existing fund that had been built under existing regulations. The section discusses the sources and use of the Settlement guarantee fund.

5.1 Initial Level of Settlement Guarantee Fund as a Condition of Demutualization

As a condition of demutualization it was envisaged that regulations would be implemented providing as follows:

SOURCE	DSE	CSE
Exchange contribution	BDT 1,000,000,000	BDT 500,000
TREC Contributions on call by management:	BDT 250,000	BDT 250,000
TREC Contributions between second and third years	BDT 250,000	BDT 250,000
Regular contributions:		
Net Profit	5% of annual net profit of the DSE	5% of annual net profit of the CSE
Income on Fund	Any income generated from of the fund	Any income generated from of the fund
Extraordinary guarantee calls:	TREC holder must transfer into the account of the fund following the approval of the board	TREC holder must transfer into the account of the fund following the approval of the board
Penalties:	Penalties under regulation 18 of settlement regulations	Penalties under regulation 18 of settlement regulations
Default interest:	Default interest under regulation 15 of settlement regulations	Default interest under regulation 15 of settlement regulations

These regulations were made at the time of demutualization but the understanding is that the funds have not as yet been paid into the guarantee fund by the two exchanges. This is should be done as soon as possible.

5.2 Other Sources Funds for the Settlement Guarantee Fund

Most Asian jurisdictions also source funds for the settlement guarantee fund from investors and market infrastructure vehicles. Above 5% of exchange profits are to be contributed to the fund. Other funds could also be sourced from:

- 20% annual profits of CLEARCO
- Levy 0.0025% on value of trade paid by investors on each side of the transaction

5.3 Actuarial Study to Design Optimum Level of Settlement Guarantee Fund

A number of jurisdictions have developed a Monte Carlo model to anticipate the likely funding of the Settlement Guarantee Fund and the drawdowns possible from likely participant failures. It is recommended that such an actuarial analysis is undertaken for Bangladesh's cash equity markets. The concept is to look at the highest levels of volatility and market volumes to model likely defaults as wells as likely annual investor and infrastructure contributions to the guarantee fund.

5.4 CLEARCO to be Member of RTGS and Treated as a Quasi-Bank for Settlement Purposes

One of the BIS/IOSCO recommendations is that where possible central bank funds should be utilized for final delivery versus payment and BSEC and Central Bank of Bangladesh should study developments in other jurisdictions that have achieved this status.

6 Key Milestones for Development of Enhanced Cash Equity Clearing

In summary the following steps (some steps may be concurrent with others) need to be completed to introduce enhanced clearing:

- a) BSEC to promulgate National Clearing and Settlement regulations;
- b) Incorporate CLEARCO and have Memorandum and Articles of Association Approved by BSEC;
- c) Finalize ownership structure and shareholders of CLEARCO;
- d) Inject initial capital by shareholders into CLEARCO;
- e) Appoint independent Board, CEO, and Management of CLEARCO;
- f) Build/BUY National Clearing and Settlement System;
- g) Fund Settlement Guarantee Fund in accordance with demutualization agreement;
- h) BSEC to implement risk based capital requirements and TREC participants to comply with new capital levels;
- i) Begin applications for Individual Clearing and General Clearing members who can meet conditions of participation;
- j) Undertake actuarial study of Settlement Guarantee Fund likely growth and drawdowns;
- k) Install necessary governance and risk management systems;
- l) Test implementation of new IT system and build linkages to CDBL and participant back offices as well as cash settlement methodology;

- m) BSEC to work closely with Central Bank of Bangladesh to utilize Central Bank money via RTGS for settlement by making CLEARCO a Quasi-Bank for settlement purposes.
- n) Set launch date for enhanced Cash Equity clearing and settlement

PART II – Introduction of a CCP model for Cash Equity markets

7 Transition from Enhanced Clearing to a CCP Process

Part I discussed improvements to Bangladesh's cash equity markets clearing and settlement that would enhance the current process which currently leaves the residual risk with the two exchanges. The movement to enhanced clearing would see risk concentrated in a single national CLEARCO which would retain residual risk but which relies on well capitalized TREC clearing participants, risk management practice and systems at CLEARCO and financial reliance on the capital of CLEARCO and access to a Settlement Guarantee Fund maintained by CLEARCO. However, should the financial resources run out then there is a risk that CLEARCO would fail and residual contracts for equity trades would have to be unwound and investors could suffer and the market would collapse as the clearing system would be non-functional and would have to be replaced or bailed out by the Government. This occurred in Hong Kong in 1987 when the HK Futures exchange clearing entity failed and the HK Government had to step in and stabilize the market. Subsequently HK developed a robust CCP mechanism.

This Part II looks at what then would be required to see a transition from the proposed enhanced clearing and settlement proposed in Part I to a CCP mechanism.

7.1 What is a CCP

A recent study by a BSEC committee looking at the development of a CCP for the Bangladesh market explained the purpose and features of a CCP as follows:

A clearing corporation acts as a central counterparty when it interposes itself as legal counterparty to both sides of the transaction in a market. Contracts are entered into bilaterally and then transferred to the clearing corporation by novation. It becomes the buyer to every seller and the seller to every buyer. By achieving netting of underlying trade obligations, the use of a central counterparty reduces both pre-settlement credit exposures and any settlement exposures. The adoption of a central counterparty directly reduces counterparty credit risk. In this way, it reduces replacement risk. It does not eliminate principal risk, and therefore, CCPs in general must be organized so as to be compatible with DVP. Through multilateral netting, CCPs also reduce the number of trades

that need to be settled. In order to do so, the legal basis for the CCP's activities must be sound: it must clearly define novation so that subsequent unwinding is not possible, it must determine the moment when novation takes place (normally, simultaneously with trading) and the moment of settlement finality.

In addition, central counterparties provide the typical benefits of an insurance scheme: for risk adverse market players, the central counterparty makes it possible to swap a remote but potentially very large loss, with a more predictable but smaller loss. Without CCPs the default of one player is likely to fall disproportionately on a few participants, while the CCP allows socialization of the ensuing loss.

Moreover, market efficiency can be enhanced if some of the risk is transferred to a third party, which is willing to bear it (e.g. an insurance company). Overall, relative to a situation in which companies have to set bilateral limits and screen the counterparty risk of each market participant, the CCP should allow greater liquidity and less absorption capital.

Apart from handling counterparty risk, depending on how it is structured, CCPs also offer two main advantages to participants: the multilateral netting of positions and the anonymity of trading. Multilateral netting of exposures, including for balance sheet reporting – where permitted by accounting standards – is particularly beneficial for companies that trade frequently with each other, thus creating a large web of bilateral exposures. Through the decreased exposure to market risk, firms could increase their activity in the market and boost volumes and liquidity. The benefit, however, is likely to be minimal for the low volume participant. Operational risk must also be monitored closely.

In general, CCPs should have financial arrangements and operational requirements that allow the successful settlement of all trades, even if a number of system participants default under stressful market conditions.

7.2 Standard Features of a Central Clearing Corporation (CCP)

- a) The clearing mechanism should be organized as separate and independent centralized entity in the form of a Clearing Corporation;
- b) Governing Board of the Clearing Corporation should be immune to any interference or direct/indirect pressure by trading interests;

- c) The clearing corporation must perform full novation, i.e. the clearing corporation should interpose itself between both legs of every trade, becoming the legal counterparty to both or alternatively should provide an unconditional guarantee for settlement of all trades;
- d) The clearing corporation should have the capacity to monitor the overall position of participants across both cash and derivatives markets for those participants who are participating in both;
- e) The level of initial margin required on a position should be related to the risk of loss on the position. The initial margin should be large enough to cover the one-day loss that can be encountered on the day's position;
- f) The clearing corporation must establish facilities for electronic funds transfer (EFT) for swift movement of margin payments;
- g) In the event of a participant default in meeting its liabilities, the Clearing Corporation should have processing capability to require either the prompt transfer of client positions and assets to another participant or to close-out all open positions. The Clearing Corporation should have recourse to disable the Clearing/trading participant from trading in order to stop further increase in his exposure; and
- h) The requirements for capital adequacy and upfront margin should be set taking into account the volatility of the underlying market.

7.3 Key Differences Between “Enhanced Clearing and Settlement” and a CCP

Several key differences are noted between the two concepts of “enhanced clearing” and a CCP. These are:

- a) Under a CCP the trades on market are immediately novated to CLEARCO who acts as the guarantor to both sides of the trade. The TREC participant is no longer liable on the default of participants to have the trade unwound and therefore liable to residual risk. Novation is final;
- b) In addition to contributions to the Settlement Guarantee Fund, participants are liable to post margins assessed by reference to the volatility of the security traded.
- c) Participants may have to post additional margins if their trades are providing abnormal risk or concentrated risk; and

- d) The CCP may also be organized to clear and settle both cash equity markets and derivative trading. Enhanced clearing could not contemplate derivatives as it requires margins and collateral to be posted due to the leverage nature of derivative trading. Derivatives require a CCP mechanism to ensure proper risk management.

7.4 Should a Derivative Market Have a Separate CCP?

It is quite usual to separate derivatives clearing and settlement from cash equity market clearing and that decision can be independent of moving from enhanced clearing to a CCP for the cash equity markets.

8 Roadmap to a CCP Process

Leaving aside the question of developing derivative market products and concentrating on cash equities, the following steps will be necessary to develop a CCP beyond an enhanced clearing and settlement CLEARCO.

These steps would be:

- a) Develop measures of volatility for each counter/instrument in the cash equities market;
- b) Enable certain volatile and illiquid counters to be treated as “isolated trades” where their multilateral settlement may pose unacceptable risk;
- c) Ensure the introduction of robust and clear rules covering short selling and stock borrowing and lending which will facilitate liquidity provision and stock buy ins;
- d) Explore whether CLEARCO could operate a stock borrowing and lending service for TREC holders;
- e) Develop an environment which enables continuous net settlement where CLEARCO can buy in securities that have not been delivered and payout monies for settlement failures;
- f) Ensure the enhancement of Bankruptcy laws to provide protection to CLEARCO from preference payments much like a bank that provides a mortgage has a carve out from bankruptcy priorities;
- g) Develop collateral management systems to support CLEARCO's efforts through CDBL facilitating electronic real-time transfer of securities and blocking of securities;

- h) Develop or purchase software that assesses the value of risk of net positions of a participants across different instruments and allows immediate or regular periodic electronic funds transfer to collect or pay away margin adjustments; and
- i) Synchronize the monitoring of capital adequacy reporting between the BSEC and CLEARCO to ensure one process to monitor and measure capital adequacy requirements.

9 Recommendations on ADB Conditionality and Possible Technical Assistance

There are several actions that should be undertaken either in the short (next four to six months) or medium term (twelve to eighteen months) and there are some areas where ADB could provide technical assistance over the next eighteen months.

9.1 Potential 1st Tranche Policy Actions:

- a) BSEC to finalize and implement Risk Based Capital Adequacy requirements for TREC holders (and other licensees), this should also ensure clarification of capital requirements for Margin Finance activities and the lifting of suspension of the margin finance requirements for client loan to equity ratio.
- b) DSE and CSE to actually transfer monies to the Settlement Guarantee Fund to sum as agreed as part of the demutualization requirements
- c) BSEC to promulgate National Clearing and Settlement Regulations and establish a time-bound action plan for the exchanges to progress the incorporation, capitalization, licensing and establishment of CLEARCO
- d) BSEC to issue Stock Borrowing and Lending as well as Short Selling rules that support continuous net settlement and allow clients to sell stock where they have a presently exercisable and unconditional right to vest the security in the purchaser by virtue of having either borrowed the stock under a securities borrowing and lending agreement or they have a title to other security which is convertible into or exchangeable for the security to which the sale relates or other option or rights to subscribe to and to receive the security to which the sale relates. This latter clarification will enable day trading in the Bangladesh markets which currently is not possible due to the current clearing and settlement mechanism.

9.2 Potential 2nd Tranche Policy Actions

- a) CLEARCO to be operational offering enhanced clearing with professional independent management and proper operational risk management;

- b) CLEARCO has installed and successfully operating a new national clearing and settlement operation;
- c) Items to progress establishment of CCP:
 - Bankruptcy Laws to provide carve out of priority rules for a CCP; and
 - Central Bank of Bangladesh and BSEC to consider and agree steps for CLEARCO to use Central Bank funds for settlement via access as a quasi-bank to the RTGS system; and
- d) BSEC and CLEARCO to have undertaken actuarial study and implemented the recommended level of capital and Settlement Guarantee Fund contributions for individual and general clearing participants of CLEARCO.

9.3 Technical Assistance

- a) Consultancy to assist with development of National Clearing and Settlement regulations and rewrite and implementation of SBL rules and Short Selling rules to allow continuous net settlement and isolation of certain trades;
- b) Actuarial consultancy to study volatility of Bangladesh equity market and make recommendations on the development and funding of the Settlement Guarantee Fund;
- c) Capacity building for CLEARCO and BSEC relating to the operation of enhanced clearing and settlement as well as the needs and operation of a CCP; and
- d) Assistance with improvements to linkages with CDBL and RTGS to ensure straight through processing and finality of Delivery vs Payment for equity clearing utilizing continuous net settlement and where necessary isolation of risky trades.

10 Conclusion

Bangladesh's capital markets currently have sub-optimal clearing and settlement processes which currently carry significant risk for the exchanges and investors and may lead to systemic risk problems for regulators.

By firstly moving to enhanced clearing and settlement through the development of a National Clearing and Settlement System owned and operated by CLEARCO and then secondly facilitating CLEARCO's transition to a CCP Bangladesh can vastly improve its clearing and settlement infrastructure and reduce risk to exchanges, their participants, investors and regulators.

APPENDIX 9

PROMOTION OF SUKUK IN BANGLADESH

APPENDIX 9: Promotion of Sukuk in Bangladesh

1	Sukuk Definition	1
1.1	Types of Sukuk	1
1.1.1	Mudarabah	1
1.1.2	Musharakah	1
1.1.3	Istisna'a	2
1.1.4	SUKUK Al-Salam	2
1.1.5	Murabaha	2
1.1.6	Ijarah	2
1.2	Structure:	2
1.3	Uses of Sukuk Funds	3
1.3.1	Project-specific Sukuk	3
1.3.2	Assets-specific Sukuk	3
1.3.3	Balance Sheet-specific Sukuk	3
	Global Sukuk Issuance	4
1.4	4	
2	Background of Islamic Banking/ Finance in Bangladesh	5
2.1	Industry Structure: No. of institutions over time	6
2.1.1	Full-fledged Islamic Banks	6
2.1.2	Conventional Banks with Islamic Banking branches and windows:	6
2.1.3	Foreign Banks with Islamic Banking Branches/Windows	6
2.1.4	Non-Bank Islamic Financial Institutions	7
2.2	Share and Growth of Islamic Banks	7
3	Cases of Islamic Bonds in Bangladesh	8
3.1	Government Initiative	8
3.2	Private Sector Initiative	9
3.2.1	Listed Corporate Bond: Mudaraba Perpetual Bond of Islami Bank Bangladesh Ltd. (IBBL)	9
3.2.2	Privately Placed: First Security Islami Bank Limited Mudaraba Subordinated Bond:	10
3.3	Promotion of Sukuk in Bangladesh	10
3.3.1	Demand Factors	10

3.3.2	Supply factors	11
4	Issues and Challenges of SUKUK in Bangladesh	11
5	Recommendations:	14
5.1	Recommendations regarding Regulatory Framework.....	14
5.2	Recommendations regarding Promotion and marketability of Sukuk	14
5.2.1	Government:.....	14
5.2.2	Corporations:	15
5.3	Recommendations regarding other aspects	15
5.4	Recommendations regarding Tax Issues	16
5.5	Turkish Sukuk Experience	16
5.5.1	Non Tax related Regulations:.....	17
5.5.2	Tax related Regulations:.....	17
6	Policy Roadmap.....	18

APPENDIX 9: Background on SUKUK

1 Sukuk Definition

In understanding Sukuk one can start with the literal Arabic translation which is “legal documents, deed and check”. Hence it can be seen as the Arabic name for financial certificate but it can be seen as an Islamic equivalent of the conventional bonds.

AAOIFI defined Sukuk as:

“Certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity”. (Page 298 of AAOIFI's Shari'ah Standards for Financial Institutions 2004-5)”

One can also see the definition of Sukuk as a commercial paper that provides an investor with ownership in an underlying asset. In general, all assets are eligible to be classified as SUKUK depending on the type Sukuk (tradable and non-tradable). For example, in Sukuk Al Salam, seller agrees to supply specific commodity to buyer while Istisna or Ijarah Sukuks are used for real estate project, power project and other industrial project. It is asset-backed trust certificates reflecting ownership of an asset or its usufruct (earnings or fruits). It has a stable income and complies with the principle of Shari'ah. Unlike conventional bonds, Sukuk needs to have an underlying tangible asset transaction either in ownership or in a master lease agreement.

1.1 Types of Sukuk

1.1.1 Mudarabah

Mudarabah Sukuk represents projects or activities established under the Mudarabah system. This is an agreement between two parties, where one party provides the financing (capital) and the other party (entrepreneur) carries out the business operations while the profits are distributed at a pre – determined ratio between the parties. In cases of loss only the provider of capital bears the loss.

1.1.2 Musharakah

Musharakah Sukuk is used for raising funds in the form of equity finance to fund new projects. These are similar to Mudarabah Sukuk and are structured in such a way that requires both the parties to provide financing to the project and in cases of loss both the parties would share the loss in proportion of their investment.

1.1.3 Istisna'a

Istisna'a Sukuk is used for raising funds to provide pre – financing for real estate development, major industrial projects and heavy equipment purchases. The financial institution funds its client during the construction or the purchase of the asset where the financial institution holds on to the title of the asset and upon completion of the construction or purchase, transfers the title to its client for a deferred payment or leases the asset under an Ijarah Sukuk.

1.1.4 SUKUK Al-Salam

These certificates are used for raising funds for the purpose of financing a sale. The buyer and seller of the Sukuk enters into an agreement where the buyer pays in full (usually a discounted price for early payment) for a certain commodity on the spot while a future date of delivery is fixed for the seller. The Al – Salam Certificates is similar to a forward contract in a sense that some of the risks are being eliminated as the price and date of delivery is fixed in advance.

1.1.5 Murabaha

These certificates are usually structured in a cost-plus financing method and mostly used for short term financing. Here, the Islamic financial institution purchases and takes the ownership of the necessary equipment or commodities from a third party and sells it to its customer(at a stated mark-up added to its cost price) where the customer makes the payment at a future date.

1.1.6 Ijarah

These certificates are mostly used for project financing (usually long term in nature) and has a leasing structure with an additional right given to the lessee to buy the assets at the end of the contract period (similar to a capital lease). The rental rates on the lease can be set to be either fixed or floating and the return from the leased assets is passed to investors in the form of coupon and principal payments.

The international Sukuk issuance data from 2011 to Jan 2013 shows that Sukuk al Ijarah contains the largest segment (48%) among all types of Sukuk issuance.

1.2 Structure:

- Sukuks must be asset linked.
- In case of asset based Sukuk, the originator of Sukuk only passes the beneficial ownership of the asset to the Sukuk holders while the underlying asset remains on the balance sheet of the originator. The investors are paid from originator/obligor's cash flows. In such scenario, the investors only have the recourse to the originator as there

has been no true sale and the Sukuk holders cannot sell the underlying asset to a third party.

- In case of asset backed Sukuk, the underlying asset is transferred to the Sukuk holders on a true sale basis (i.e. the title of the asset is passed from the originator to a Special Purpose Vehicle, SPV, which in turn is owned by the Sukuk holders). The Sukuk holders are paid from the revenue generated by the underlying asset. Here, the Sukuk holders have the recourse to the asset (since they can sell the asset to a third party) in case of default. Some important features of the underlying asset are that the asset must be acceptable according to Shari'ah principles and be able to generate cash flows.
- The profit payment to the Sukuk holders can be fixed or benchmarked to the inter-bank offer rate plus a margin.

1.3 Uses of Sukuk Funds

The most common uses of Sukuk can be named as project specific, asset-specific, and balance sheet specific.

1.3.1 Project-specific Sukuk

Under this category money is raised through Sukuk for specific project. For example, Qatar Global Sukuk issued by the Government of Qatar in 2003 to mobilize resources for the construction of Hamad Medical City (HMC) in Doha. In this case a joint venture special purpose vehicle (SPV), the Qatar Global Sukuk QSC, was incorporated in Qatar with limited liability.

1.3.2 Assets-specific Sukuk

Under this arrangement, the resources are mobilized by selling the beneficiary right of the assets to the investors. For example, the Government of Malaysia raised US\$ 600 million through Ijara Sukuk Trust Certificates (TCs) in 2002. Under this arrangement, the beneficiary right of the land parcels has been sold by the government of Malaysia to an SPV, which was then re-sold to investors for five years. The SPV kept the beneficiary rights of the properties in trust and issued floating rate Sukuk to investors.

1.3.3 Balance Sheet-specific Sukuk

An example of the balance sheet specific use of Sukuk funds is the Islamic Development Bank (IDB) Sukuk issued in August 2003. The IDB mobilized these funds to finance various projects of the member countries. The IDB made its debut resource mobilization from the international capital market by issuing US\$ 400 million five-year Sukuk due for maturity in 2008.

1.4 Global Sukuk Issuance

There had been significant developments in each asset class of Islamic finance since 2010 including a growing number of industry players, particularly in new jurisdictions, the introduction of regulatory reforms, incentives and various government-sponsored initiatives to establish Islamic financial services in various markets, as well as an IFSI whose assets size were USD 1.3 trillion as at end-2011.

A presentation by “Capital Market Board of Turkey” cited that by 2020, asset size of the Islamic finance industry is expected to surpass USD 6.5 trillion mark which is around USD 1.6 trillion in 2012.

Breakdown of Islamic Financial Assets (USD Billion) 2012E					
Region	Banking	Sukuk	Islamic Funds	Takaful	Total
Asia	171.8	160.3	22.6	2.7	357.4
GCC	434.5	66.3	28.9	7.2	536.9
MENA	590.6	1.7	0.2	6.9	599.4
Sub-Saharan Africa	16.9	0.1	1.6	0.4	19.0
Others	59.8	1.0	10.8	-	71.6
Total	1,273.6	229.4	64.1	17.2	1,584.3

Source: IFSB IFSI Stability Report 2013

Sukuk had gained a lot of popularity over time and has been successful in many countries around the world (both in Islamic and non – Islamic countries). As of September 2013, the number of Sukuk issuances in various countries overtime stood at 3,543 issues which amounted to USD 488.2 bn.

GLOBAL AGGREGATE SUKUK ISSUED BREAKDOWN BY COUNTRY (JAN 96 – SEP 13)		
Country	No. of Issues	Amount Issued (\$ mn)
Malaysia	2,438	324,576.9
UAE	73	47,876.4
Saudi Arabia	64	39,296.0
Indonesia	216	19,924.1
Qatar	19	19,245.6

GLOBAL AGGREGATE SUKUK ISSUED BREAKDOWN BY COUNTRY (JAN 96 – SEP 13)		
Country	No. of Issues	Amount Issued (\$ mn)
Bahrain	273	13,918.5
Pakistan	57	6,348.9
Turkey	9	5,469.7
Brunei Darussalam	95	4,980.7
Kuwait	22	2,992.4
Singapore	9	984.2
United States	3	765.7
United Kingdom	5	279.1
China	3	274.7
Yemen	2	251.5
Sudan	3	220.9
Germany	2	190.9
Gambia	242	149.2
Iran	4	132.8
Jordan	1	120.3
Japan	1	100.0
Kazakhstan	1	73.3
France	1	0.7
GRAND TOTAL	3,543	488,172.0

Source: Islamic Finance Gateway – Sukuk Perceptions and Forecast Study 2014

2 Background of Islamic Banking/ Finance in Bangladesh

Bangladesh is the third largest Muslim country in the world with around 160 million population of which 90 percent are Muslim. The emergence of Islamic Banking in Bangladesh in that sense is a natural development in the banking and finance sector. At present there are 8 full fledged Islamic banks in operation. Besides that, there are 17 conventional banks offering Islamic banking services under special Islamic banking window.

2.1 Industry Structure: No. of institutions over time

2.1.1 Full-fledged Islamic Banks

At present there are eight full-fledged Islamic Banks operating in the country¹. They are:

- Islami Bank Bangladesh Limited (1983) Al Arafah Islami Bank (1995)
- Social Islami Bank Ltd. (1995)
- Shahjalal Islami Bank Ltd. (2001)
- ICB Islamic Bank 2008: (Incorporated in 1987 as Al Baraka Bank; Oriental Bank in 2002)
- Exim Bank Ltd. (1999; conversion to Islamic Banking in 2004)
- First Security Islami Bank (1999; conversion to Islamic Banking in 2009)
- Union Bank Limited (2013)

2.1.2 Conventional Banks with Islamic Banking branches and windows:

- Prime Bank Limited (1995)
- South East Bank Limited (2003)
- Premier Bank Limited (2003)
- The City Bank Ltd. (2003)
- Dhaka Bank Limited (2003)
- AB Bank Limited (2004)
- Jamuna Bank Limited (2004)
- Bank Asia Limited (2008)
- Trust Bank limited (2008)
- Standard Bank Limited (2009)
- Sonali Bank (2010)
- Agrani Bank (2010)
- Pubali Bank (2010)

2.1.3 Foreign Banks with Islamic Banking Branches/Windows

- Standard Chartered Bank (*Saadiq*; 2004)

¹Shari'ah Banking: Bangladesh Perspective; M. Azizul Huq, Islamic Banking Consultant

- HSBC (*Amanah*; 2004; Now closed)
- Bank Al-Falah (2005; One branch)

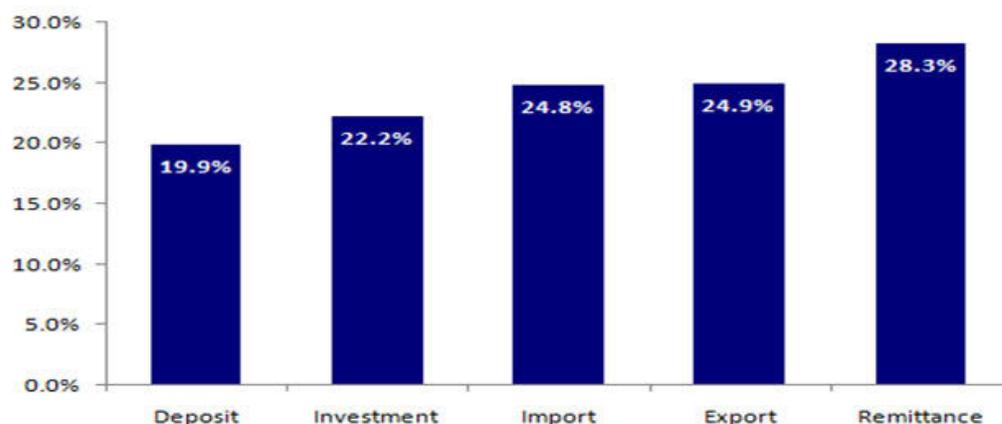
2.1.4 Non-Bank Islamic Financial Institutions

- Islamic Finance and Investment Ltd. (IFIL); 2001.
- Hajj Finance Company Limited (2006)

2.2 Share and Growth of Islamic Banks

The total amount of deposit and investment of Islamic banks and Islamic windows of conventional banks as of December 2013 stood at BDT 1.20 trillion and BDT 1.02 trillion with market shares of 19.3% and 22.2%² respectively of the banking industry. The deposit growth data in figure 2 clearly shows increasing market share of Islamic banks. Deposit of Islamic banks grew at 25.6% compared to 22.0% of conventional banks from 2009-2013 and investments exhibited a growth of 24.6% as against 20.0% of conventional banks in the same period.

Figure 1 – Islamic Bank’s Market Share in 2013 (%)



Source: *Shari’ah Banking: Bangladesh Perspective*, M. Azizul Huq, Islamic Banking Consultant

Islamic banks have diversified exposure in different sectors of the country. The share of Islamic banks in industrial sector is 19.8%, in the commercial sector 25.4%, in real estate sector 16.22%, in agriculture 3.43% and in transport 22.57% as on September 2013 (SBS of Bangladesh Bank) shown in the graph below.

Figure 2 – Sector-wise investment of All Banks and Islamic Banks

² Deposit and investment growth data from “*Shari’ah Banking: Bangladesh Perspective*; M. Azizul Huq, Islamic Banking Consultant”



Source: Shari'ah Banking: Bangladesh Perspective, M. Azizul Huq, Islamic Banking Consultant

3 Cases of Islamic Bonds in Bangladesh

3.1 Government Initiative

At present, in Bangladesh the concept of issuance of Islamic financial instruments is at an emerging stage. Until 2004, there were not any issuance of Islamic financial instruments. However, in order to assist Islamic banks and financial institution in meeting SLR (statutory liquidity ratio); Bangladesh Bank had issued a Mudaraba Perpetual Bond (MPB) ("Bangladesh Government Islamic Investment Bond (GIIB) " in October, 2004.

According to Bangladesh Bank, the Islamic bonds available in Bangladesh are 6-month, 1-year and 2- year which were introduced by Bangladesh Bank in FY05, under Shari'ah laws. However, in September 2014, the central bank had cut the maturity period of Islamic bonds by half to make them attractive under the new guidelines which will be known as "Islamic Investment Bond Guidelines 2004 (Amended 2014)". The profit of Islamic bonds will be equal to the profit of a three-month fixed deposit scheme of the issuing Islamic banks, replacing the profits rate for savings deposits. These new guidelines would now allow Shari'ah-based banks and financial institutions to use the bonds as an instrument for repo operations.

The characteristics of the Islamic Investment Bond are:

- The bond will be based on the principles of Mudaraba and governed by the Islamic Shari'ah.
- Profit Sharing Ratios (PSR) will be different for each deal where Bangladesh Bank will act as Mudarib.

- The minimum investible amount is be BDT 0.1 mn.

3.2 Private Sector Initiative

In the private sector, the bond issuance in the Islamic form took place in the banking industry with two Islamic Banks, Islami Bank Bangladesh Ltd. (IBBL) and First Security Islami Bank Limited (FSIBL), coming up with “Mudaraba” bond in order to broaden and diversify their capital base. In case of Islami Bank this was a listed bond named, “Mudaraba Perpetual Bond of Islami Bank Bangladesh Ltd. (IBBL)” while for First Security Islami Bank this was a privately placed bond named, “First Security Islami Bank Limited Mudaraba Subordinated Bond”. These are effectively a kind of a balance sheet financing Sukuk. Though it is interesting to note that they did not deliberately brand those as “Sukuk” understandably because of potential confusion it may create in absence of a proper and separate regulatory frame work or even an absence of the terminology in the regulatory literature.

3.2.1 Listed Corporate Bond: Mudaraba Perpetual Bond of Islami Bank Bangladesh Ltd. (IBBL)

Features:

- Perpetual bond with Pre-determined Interest rate is and no redemption facility.
- MPB holders will not be entitled to any dividend.
- Income from investment activities will be distributed at an additional rate equivalent to 10% to the MPB.
- Issuance of MPB to meet the capital adequacy ratio of the Bank.
- The Minimum subscription amount is Tk. 5,000 or multiple of Tk.5,000.
- MPB will have a prior claim over the shareholders in obtaining profit and refunding principal in case the bank liquidates.
- In the above two case, the bondholders will have a subordinated claim to the depositors.
- MPB will be listed with both Bourses of the country and will remain freely transferable depending on the market demand.
- To secure the interest of the Bondholders, IBBL has already agreed to create a floating charge to the extent of BDT 3,000 mn on the present and future assets of the bank in favor of the trustee.
- IBBL's corporate guarantee will further cover the security of the bond.

3.2.2 Privately Placed: First Security Islami Bank Limited Mudaraba Subordinated Bond:

Investment Highlights:

- Emerging Credit Rating Limited rated the bond, carrying 'A: ID implying 'stable' outlook.
- The bond will provide semi-annual coupon, estimated to generate Yield to maturity (YTM) of 15.76% over its 6 years term. This issuance has an embedded redemption option with 20% each year starting from the 2nd year since issuance.
- The FSIBL Mudaraba Subordinated Bond is Islamic-Shari'ah compliant and available to both Islamic and General Investors. Total periodic return comprise- 1.10x of the weighted average of the highest yield of Mudaraba term Deposit for the preceding 180 days of the coupon date and 2.25% of FSIBL's periodic profit before tax excluding statutory reserve.
- In case of any delay by the Issuer, pre-tax profit excluding statutory reserve will be shared at a rate of 4.5% instead of 2.25%, in addition to Basic Profit Rate.
- The bond will be freely transferrable to the terms and conditions of the Bond Documents.
- Under new management since 2005, FSIBL has succeeded in executing an aggressive turnaround and roll out strategy, opening 55 branches over the last 3 years, currently standing at 93 Branches as of October 03, 2012.7
- FSIBL is the fastest growing Islamic Bank amongst all Islamic Banks over the last 3 years in terms of Deposit, Investment and Profit Growth, as well as branches increased in the last 3 years out of all private commercial banks.

3.3 Promotion of Sukuk in Bangladesh

From the above discussion it is clear that given the current scenario of the country's financial market, there is an ample potential for both demand and supply of Sukuk.

3.3.1 Demand Factors

As mentioned in the previous section, the Islamic financial institutions control around 22% of the total banking assets. This large market share of Islamic financial products indicates that there is a potential demand for Shari'ah complaint capital market instruments (bonds) from the same depositor/investor group who are inclined to the current money market products of the Islamic banking community.

There is also a latent demand for Sukuk from the Islamic financial institutions e.g. Islamic Banks, Islamic Insurance companies, Islamic NBFIs, Islamic Micro Finance Institutions, Islamic Mutual Funds, etc. as they have rational compulsion for investment in Shariah complaint capital market products.

We also believe that if the Sukuk is attractively priced and ultimately offers a lucrative tax based yield it would attract all other investors as is currently being observed with a growing popularity of Sukuk even in non-Islamic communities all over the world.

3.3.2 Supply factors

The potential supplier of Sukuk can be broad based e.g. Government and Private Sector Institutions.

At present the Government of Bangladesh is regularly issuing Mudaraba Perpetual Bond (MPB) in order to assist Islamic banks and financial institution to meet their SLR. However, we believe that beyond the purpose of fulfilling their treasury requirement the government can also issue Sukuk to finance their infrastructure and other long term projects.

Banks and Financial Institutions are another major potential issuer of Sukuk. As we have observed from the discussion in the previous section that some of the Islamic Banks had already issued bond to diversify and broaden its resource base. We believe that this trend would continue in the coming days with more and more such issuance emerging from diverse type of Islamic Financial Institutions.

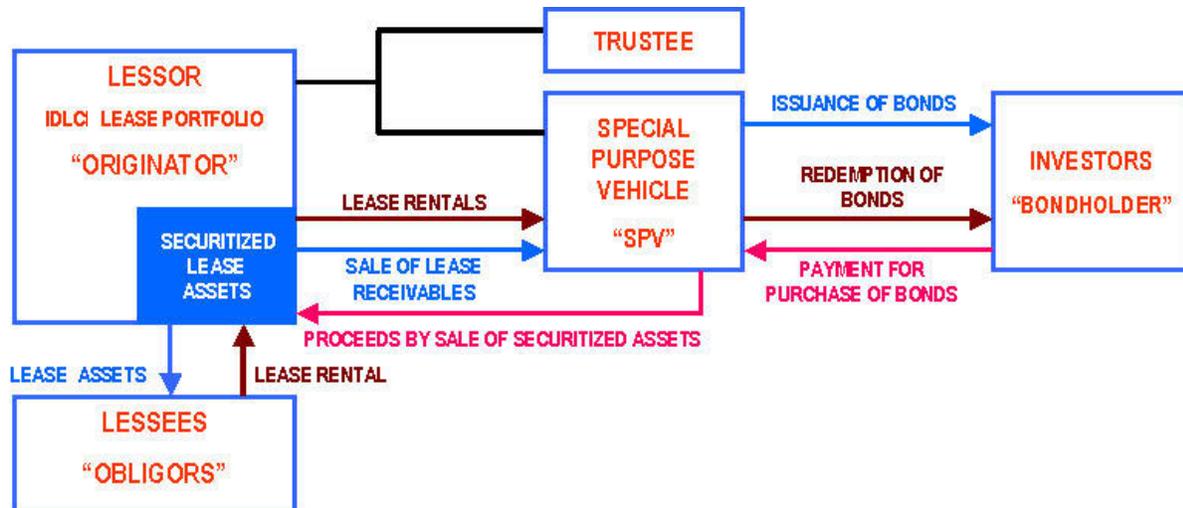
Large corporate in the private sector can also issue Sukuk to finance their long term project cost effectively.

4 Issues and Challenges of SUKUK in Bangladesh

Whether they are typically branded as "SUKUK" or not as we have noted that Islamic bond is not a new concept in Bangladesh. All the issues that have been introduced so far, however, (both under public sector i.e. Bangladesh Bank and under private sector) can be termed as a form of balance sheet financing or treasury management. And those were issued without the service of a Special Purpose Vehicle (SPV) whereas the global practice is rather wide spread use of SPV in Sukuk issuance. In our demand analysis as well we have discussed that Sukuk can be used quite extensively for mobilizing long term financing and project financing requirement of both public and private sector particularly in the popular form of Ijarah or Istishna. This type of Sukuk issuance would ideally call for using SPV.

In Bangladesh, use of SPV for issuance of bond was first introduced by some non – banking financial institutions (NBFI) like IPDC and IDLC. Back in 2004 under a World Bank program called FIDP (Financial Institutions Development Program) those institutions securitized a part of their portfolio by transferring the assets to an SPV formed under a trust structure according to the Trust Act of 1882. Particularly for IDLC the scheme was to transfer the "beneficial interest" (the monthly rentals) of the underlying lease portfolio to

ICB (a government owned investment banking company) who was appointed as the Trustee. The Trustee in turn issued series of “Zero – Coupon Bonds” against the lease rental receivables. Following is the diagram of the scheme:



The scheme however gave rise to host of issues in the areas of Legal/Regulatory, Accounting and Tax Treatment that need to be solved.

With respect to legal/regulatory issue the primary concern was whether the mere transfer of beneficial interest without the transfer of actual title to the assets would constitute a “true sale” to make the transaction “bankruptcy remote”.

As to the tax treatment question could arise in the following areas:

Capital Gain Tax: If and when the assets (in this case lease rental receivables) are transferred to SPV at a price higher than their present value.

Stamp Duty: Whether it would invoke stamp duty which is presently very high in Bangladesh to make the whole transaction economically unviable.

Income Tax: Whether the SPV will be subject to income tax.

Depreciation and Associated Tax Benefit: If the Lessor has capitalized the lease asset in his book, whether the tax benefit associated with depreciation goes over to SPV when the beneficial interest of the underlying asset is transferred.

Tax on Investment Return: And finally whether the investors will be subject to income tax on interest or dividends earned on the instruments and at what rate.

As to the resolution of legal/regulatory issue fortunately by that time the SEC had come up with a comprehensive guideline with respect to “securitization” and issuance of ABS

(Asset Backed Securities) and all such issues has to have the approval of SEC. Under that guideline if the beneficial interest of the underlying asset is transferred through assignment to a Trustee formed as a pass through structure the transaction is legally robust enough to be treated as true sale.

As to the tax treatment following steps were taken:

Capital Gain Tax: This was avoided altogether because the rental receivables were transferred at their book value. Rather in a way of credit enhancement the transferred portfolio was over collateralized as against the actual value of bond issuance. Another credit enhancing step was for issuer to take exposure in subordinated/equity tranche with lowest ranking in the receivable waterfall.

Stamp Duty: As these were issued following the ABS guideline of SEC and with the approval of both SEC and Bangladesh Bank stamp duty was waived.

Income Tax: Since SPV was formed as a “Pass Through” structure the question of income tax at SPV level was avoided.

Depreciation Benefit: The leasing industry in Bangladesh started with a practice of capitalizing lease assets by treating the contract as “Operating Lease” and claiming the associated tax benefit of depreciation though effectively they were offering “Capital/Finance Lease”. Since 2003, however, the NBR (National Board of Revenue) stopped allowing the practice of charging depreciation by leasing companies which eventually forced the leasing industry to treat the lease as “Capital Lease” by adopting the relevant accounting standard. Therefore, by the time bonds were issued in 2004-05 against the securitized lease portfolio the question of depreciation did not arise.

Income Tax: Finally, the income tax of the investors was also exempted as those were issued under zero coupon structure under a Statutory Regulatory Order. However, in 2007 the NBR has withdrawn the income tax exemption for all types of financial institutions which severely damaged the prospect of those securitized bonds as they eroded the investors' base and this type of bond lost their popularity overnight. Despite that, IDLC continued to issue bond under zero coupon structure for non financial institutions.

It is very obvious that in absence of any separate law the Sukuk bond in the present context has to be issued under the guideline of bond issuance of SEC. And if these are issued with SPV structure some aspects of the experience and precedence of the NBFIs as discussed above can be replicated. Particularly, we are hopeful that the transfer of asset to SPV will get a similar treatment of stamp duty waiver. We are not sure however the tax exemptions given in the form of a structure-specific Zero Coupon bonds will be

allowed in case of Sukuk as the conventional bond is interest based instruments whereas Sukuk is a Shari'ah compliant non – interest based instrument.

Beyond the question of regulatory and fiscal treatment under the framework of conventional bond we face another grey area in case of Sukuk. And that is whether the mere transfer of beneficial interest without the transfer of actual title to the assets will be considered as Shari'ah complaint.

5 Recommendations:

The following recommendations are made regarding **non tax related issues:**

5.1 Recommendations regarding Regulatory Framework

In almost all countries which have experienced significant growth in Islamic finance assets, there has been a clearly defined and separate regulatory structure for Sukuk. For example in Pakistan the “Issue of Sukuk Regulations, 2012” is covers a number of different issues such as like issuance procedures, eligibility of the issuer, conditions to issue Sukuk, underwriting process, appointment of trustees, disclosures requirement etc. This underlines the fact that Bangladesh should move forward and establish its own dedicated Sukuk legal framework. One key area that should be addressed is the structuring of Sukuk issuance, particularly for an Ijara Sukuk for project financing, which requires the formation of a Special Purpose Vehicle ('SPV') with assets held within the SPV.

Another important initiative that needs to be taken of a central Shari'ah board which should give certification on the Shari'ah compliance of the issue as this is the most crucial requirement especially to attract investors by strengthening overall confidence on Islamic financial services.

5.2 Recommendations regarding Promotion and marketability of Sukuk

As Sukuk is a relatively new investment instrument/concept in Bangladesh, initiatives should be taken by the GoB to promote Sukuk for both short and long term financing.

5.2.1 Government:

GoB already has issued Bangladesh Government Islamic Bonds, to assist Islamic Banks' treasury management. However, much like other government treasury instruments liquidity remains an issue due to pricing and a lack of secondary market trading. Furthermore new treasury products in line with Sukuk principles maybe developed. Creation of Repo market with Shari'ah requirements and the development of documentation/master Repo agreement may also be considered. For all existing and

new products it is imperative that they are branded effectively to all stakeholders to enhance and expand the Islamic investor base.

For long term financing, government may issue Ijarah Sukuk as we believe it is the most suitable for project financing. As Bangladesh is a developing country, infrastructural development is one of the key concerns and issuing Ijarah Sukuk will mobilize long term funds to the government and broaden the Islamic investors' base.

Going forward, the government may consider the issuance of sovereign Sukuk for international market. However, sovereign Sukuk for international markets may be considered only after the government has issued a conventional sovereign bond.

5.2.2 Corporations:

According to IIFM Sukuk report the Statistics for international Sukuk Issuance illustrated from 2011 to Jan 2013, 48% of total Sukuk issuance comprised of "Sukuk Al Ijarah". For Bangladesh, we also believe that large corporate bodies can also issue Ijarah Sukuk as a means of funding their long term financing for large projects such as power and other infrastructural project. Providing fiscal incentives should also be considered in line with conventional bond issuance.

In additional to a central Shari'ah board, every company shall, before the Issue of Sukuk, appoint a Shari'ah advisor who shall ascertain that the concept on the basis of which Sukuk is structured and the business in which proceeds of the Sukuk Issue are to be utilized are not against the principles of Shari'ah.

Majority of the literature suggests that Sukuks are privately placed and any future corporate listing requirement of Sukuk should not be mandatory as there is no mandatory listing requirement for conventional debt instrument. As such it would be contradictory and issuers will be a disincentivized if Sukuk listing is made mandatory.

5.3 Recommendations regarding other aspects

Thomson Reuters Zawya, Sukuk Perceptions and Forecast Study 2014 suggest that it is crucial for both the lead arrangers and investors to have a credible credit rating for the issuance of Sukuk. Initiatives should be taken to assist and develop the knowledge and understanding of credit rating agencies of Sukuk products.

Creation of an Islamic Finance Academy covering all the domestic and international aspect on Islamic Financial services should be established to develop the required pool of specialized, competent human capital. Promoting the development of standardized products through research and innovation can also be the role of this training institute.

Establish and maintain linkage with international Shari'ah bodies, such as AAOIFI, IFSB and the IDB to ensure standardized Shari'ah compliance.

5.4 Recommendations regarding Tax Issues

Given the nature of such a Sukuk which involves transfer of assets, it has been seen in all markets where Sukuk has flourished that the tax environment needs to be supportive. One area that is important to focus on is the stamp duty laws which need to be reviewed to avoid creating a disincentive to establish such mechanism. We would note that for other asset backed securitizations, other than Sukuk issuance, there are precedents where Stamp Duty has been waived. Given that this structure is effectively a pass through, it is important to ensure Stamp Duty, and indeed other forms of tax, is exempted to make such Sukuk issuance is financially viable. We would suggest that this is clarified for Sukuk issuance.

Any profits that come about from the sale of an asset from a Sukuk SPV and selling back to the SPV are exempt from 20% corporate tax. Moreover Corporate earnings from Ijarah certificates domestically or from Treasury Sukuk al Ijarah certificates issued offshore are not subject to income tax. Earnings from Ijarah certificates issued onshore will be subject to only 10% individual income tax.

Following the Turkish example (see below), NBR should allow earnings generated through the sale of an asset by the originator to the Sukuk SPV and its sale back to the originator by the SPV are exempt from corporate tax.

We recognize that changes to tax laws is a complicated process that can have broader implications beyond the specific instruments that are being supported. So we believe that any tax changes considered by NBR should be part of a broader Islamic finance act that incorporates all the major factors needed to support sukuk growth rather than fiscal changes done in isolation.

5.5 Turkish Sukuk Experience

Bangladesh Regulators can learn from the experience of Turkey where the authorities have taken a number of steps recently to encourage the growth of the Sukuk market. In April 2010 the Turkish Capital Markets Board gave regulatory guidance on lease certificates and asset lease companies that facilitates the issuance of lease-backed Sukuk – the *Sukuk al ijarah*. Another regulatory change by the Turkish authorities in 2013 allowed for additional issuance of *Istisna*, *Murabaha*, *Mudaraba*, *Musharaka* and *Wakala* bonds. The regulation also focused on sale of ijara certificate, structure of financial institution and Special Purpose Vehicle.

5.5.1 Non Tax related Regulations:

It also allows asset SPVs to actively trade Ijarah certificate and the SPVs can be established by banks, intermediaries or the originators and can only be incorporated as a joint-stock company.

The public offering of a Sukuk al Ijarah can only be made through a licensed intermediary institution who will be the only authorized recipient of the payment of profits over Sukuk.

The private placement of Sukuk al Ijarah does not require an offering circular.

5.5.2 Tax related Regulations:

Turkish government also took steps to progress the omnibus bill entered into on June 2012 which facilitates the issuance of Sukuk al Ijarah.

Under the omnibus bill, the 20% corporate tax rate is exempted in the event of earnings generated through the sale of asset from the originator to the Sukuk SPVs and of the asset back to the originator.

Zero VAT will be applied on the sale and lease back transaction and the issued lease certificate.

Tax rate on earnings from Ijarah certificates issued onshore:

- Corporation : 0%
- Individual: 10%

The rate will differ depending on the maturity of the Ijarah certificate in case of offshore sukuk.

- 1 Year – 10%
- 1-3 years-7%
- 3-5 years – 3%
- More than 5 years-0%

Zero percent tax rate will be applied on earnings from Treasury Sukuk al Ijarah certificates issued offshore.

Tax exemption will also be applied on the following cases related to the issuance Sukuk al Ijarah :

- Real estate registry fees
- Cadastral survey fees
- Notary public fees

6 Policy Roadmap

Phases	Objectives	Target Completion Date
Phase I	<p><u>Recommendations regarding Regulatory Framework</u></p> <ul style="list-style-type: none"> • Development of Sukuk Regulatory framework • Clarification of application of Stamp Duty, and other taxation, on Sukuk SPV. • Establishment of a Central Shari'ah board 	
Phase II	<p><u>Recommendations regarding Promotion and Marketability of Sukuk</u></p> <p><u>Government:</u></p> <ul style="list-style-type: none"> • Measures to improve liquidity of existing Bangladesh Government Islamic Bonds • Development of New Government Islamic Treasury instruments • Creation of Islamic Repo market • For long term financing, government may issue Ijarah Sukuk for project financing • Sovereign Sukuk for international markets may be considered only after the government has issued a conventional sovereign bond. <p><u>Corporate:</u></p> <ul style="list-style-type: none"> • Large corporate bodies should be encouraged to issue Ijarah Sukuk as a means of funding their long term financing for large projects such as power and other infrastructural project • All companies shall, before the Issue of Sukuk, appoint a Shari'ah advisor • Ensure no mandatory listing for corporate Sukuk issuance <p><u>Other Recommendations</u></p> <ul style="list-style-type: none"> • Initiatives should be taken to assist and develop the knowledge and understanding of credit rating agencies of Sukuk products • Creation of an Islamic Finance Academy • Establish and maintain linkage with international Shari'ah bodies 	

APPENDIX 10

INTEGRATING INFORMATION AND COMMUNICATIONS TECHNOLOGY (ICT)

APPENDIX 10: Integrating Information and Communications Technology (ICT)

1	Introduction & Background	1
2	Present Context	1
3	ICT Strategy and Roadmap	2
3.1	ICT Strategy	3
3.1.1	Guiding Principles	4
3.1.1.1	International best practice	4
3.1.1.2	Compatibility.....	5
3.1.1.3	Sustainability.....	5
3.1.2	Other Strategic Considerations	6
3.2	ICT Roadmap	7
4	Current Requirements – Mission Critical Systems	7
4.1	Key Objectives	7
4.2	Mission Critical Information Systems – RIS & ERP	8
4.2.1	Regulatory Information System (RIS)	8
4.2.2	Enterprise Resource Planning (ERP) System	9
4.2.3	Integration, Linkages and Interfaces	10
5	Sourcing - Mission Critical Systems	11
6	Initial Cost Projections – Mission Critical Systems	11
7	Approach – Next Steps	12

APPENDIX 10: Integrating Information and Communications Technology (ICT)

1 Introduction & Background

This Appendix addresses the matter of adopting and integrating ICT into BSEC's operations. The suggestions we make in this document have been developed based on a series of interviews of key BSEC personnel and the knowledge we have developed of BSEC's operations over the course of our work under CMDP II and CMDP III; our work in assisting BSEC in designing and acquiring its "legacy" systems under two consecutive TA Projects (1998-2001)¹; and our experience in advising financial regulators in other countries featuring emerging capital markets under circumstances similar to those present in Bangladesh.

2 Present Context

The use of information and communications technology (ICT) by the BSEC to facilitate its regulatory and administrative functions is minimal at present and limited to a small local area network (LAN) that connects personal computers (PCs) and provides users with basic office applications (email, MS Word & Excel) and access to the Internet.

BSEC also utilizes certain components of a legacy system (the Securities & Exchange Commission Automation System - SECAS) that was developed with ADB assistance in 1998-2000. SECAS originally consisted of the following components/modules:

Regulatory Modules

- Registration & Licensing
- Compliance & Enforcement
- Supervision & Monitoring
- Surveillance
- Mutual Funds
- Legal Affairs

Administrative Modules

- System Administration
- Document Tracking
- Executive Information
- Accounting/Financial Statements
- Personnel

Certain SECAS components/modules remain in use today, but many have been retired because they have not been updated to keep up with BSEC's evolving business processes & procedures. One of the principal reasons for this gradual "obsolescence" is that Visual Basic 6.0 (VB6), the language used to develop and maintain SECAS, is no longer supported by Microsoft (official support was terminated in 2008). This raises the risk of potential compatibility issues with current (and future) versions of Microsoft's

¹ The development of information systems for the SEC commenced in 1998 under a UNDP financed TA Project (*Strengthening the Securities and Exchange Commission of Bangladesh*) and was continued and finalized under ADB TA No. 2913-BAN, *Capacity Building for the Securities and Exchange Commission and Stock Exchanges* (1998-2000). Both projects were implemented by The Aries Group, Ltd. and ISC.

operating system (i.e. Windows 7 & 8). To ensure compatibility and upgradability, SECAS would need to be converted to Visual Basic .NET (VB.NET), Microsoft's designated successor to VB6. VB.NET compiles and runs using the .NET Framework and is not backwards compatible with VB6. While automated conversion tools exist, fully automated conversion is often not possible for most applications, thus (prohibitively) raising the cost of a conversion initiative.

BSEC has not converted SECAS to VB.NET, and this has made updating the components/modules difficult or impossible. Over the years, as fewer of BSEC's needs/requirements have been met by SECAS, various components/modules have been retired and replaced with workaround solutions. For example, accounting and personnel management are presently done with the help of MS Excel spreadsheets; the Corporate Finance Department reviews hard copies of issuer financial statements manually with no assistance from automated analytics; the IPO Department reviews & analyzes hard copies of IPO applications with no assistance from automated analytics.

The problem of maintaining and updating an application developed in VB6 has been compounded by the limited resources of BSEC's IT Department. Our understanding is that the level of staff for the IT Department has not changed since we recommended the establishment of an IT Department (and assisted in the selection of its staff) in 1999.² This level of staffing should be revisited (and potentially augmented) as it may be insufficient in today's hyper-connected and automated environment.

3 ICT Strategy and Roadmap

Responsive, stable, and secure information and communications technology capabilities are essential to BSEC's mission. To meet the broad demands of internal and external stakeholders, BSEC must provide expertise, capabilities, and services in systems development and support. BSEC's IT Department must be able to meet the needs for data, information, and knowledge management; collaboration and information sharing; telecommunications and network support; enterprise-wide information security; technical support; and incident management.

BSEC recognizes the need to modernize and transform its processes and procedures (operations) from being "paper-bound" to being more responsive to a rapidly evolving environment, facilitated by information and communications technology (ICT). Such a transformation holds the potential of dramatically improving BSEC's effectiveness and vitalizing/accelerating every facet of its operations - from internal/external communications to the manner in which documents are filed, retrieved and analyzed.

² The establishment of an IT department was recommended in 1998 under a UNDP financed TA Project (*Strengthening the Securities and Exchange Commission of Bangladesh*) and was achieved under ADB TA No. 2913-BAN, *Capacity Building for the Securities and Exchange Commission and Stock Exchanges* (1998-2000).

Considering BSEC's projected growth and the anticipated development path for the capital markets, communicating with and managing BSEC's rapidly growing professional and support staff and overseeing complex capital markets requires utilizing up-to-date modern technology to facilitate and integrate BSEC's various work streams. BSEC's recent acquisition of its market watch surveillance system (MWSS) to monitor trading on the two stock exchanges has been a big step in this direction.

In Appendix 2 (Legal, Regulatory and Policy Issues) of this report we have suggested that BSEC develop and adopt a strategy and phased plan (roadmap) for accomplishing its ICT objectives. Such a strategy and plan/roadmap should be based on a comprehensive requirements analysis of current and projected operations and a careful analysis of BSEC's specific informational and automation needs.

3.1 ICT Strategy

Areas that may be addressed in an overall Information and Communications Technology Strategy may include:

- Management structure, staffing and training/skills development;
- Systems administration – to include hardware and software acquisition and maintenance; network administration; systems integration and compatibility; system verification and testing; systems maintenance and managing obsolescence; contingency systems; data management (integrity, availability, archiving, backup and version control); general office automation systems (such as word processing, desktop publishing, spreadsheet and presentation software); specialized task-specific systems; network management; and physical environment considerations;
- Procurement and financial management – to include cost estimates and budgets; expenditure control; financial planning and reporting; audit procedures; supply and inventory management; procurement policies and procedures and contract management;
- User management and support;
- Information privacy/security standards, encryption and virus protection;
- Communication systems.

The foundation of BSEC's strategy for ICT service delivery should be based on effective and reliable information technology infrastructure, information sources, and business solutions, reflecting a multi-year information technology strategy that will:

- Provide resilient (fault-tolerant) infrastructure for BSEC's applications and critical services, including e-mail;

- Create integrated data architectures and provide end-user access to current, historic, and forecast information for regulated entities;
- Provide access to solutions, information, and services using reliable desktop, laptop, and hand-held devices that meet or exceed established performance requirements;
- Focus resources and activities on data collection, data management, and data analysis and visualization, supporting BSEC's regulatory, supervisory and administrative activities;
- Manage BSEC's application portfolio to maintain the relevance and usefulness of applications, remove redundant capabilities and retire end-of-lifecycle applications, thereby reducing operating costs and reallocating resources to priority enterprise requirements;
- Realign BSEC's IT staff profile, training, and skills with its target architecture and information technology road map, creating an agile, responsive ICT Team to enable the fulfillment of mission objectives and requirements.

BSEC's ICT Strategy and Roadmap should also recognize the threat that breaches of information security represent to its principal stakeholders and to public confidence, and should include:

- Strategies and initiatives for regular monitoring of the compliance of regulated entities with laws and regulations concerning information security;
- Sharing best practices; and
- Initiatives to take enforcement actions to ensure compliance.

It should also ensure BSEC's own compliance with best practices and standards for information security, and include initiatives to strengthen the internal security of sensitive information.

3.1.1 Guiding Principles

We would suggest that the following principles guide BSEC's ICT Strategy.

3.1.1.1 International best practice

Any upgrade in the BSEC's systems, operating practices and policies should be based on internationally accepted best practices to facilitate the accomplishment of the BSEC's regulatory supervisory and administrative objectives.

3.1.1.2 Compatibility

Solutions (hardware and software) should be designed to ensure compatibility with existing and anticipated technologies in general use – i.e. by BSEC's stakeholders and more generally by the business community in Bangladesh. It is suggested that the following principles should be observed:

Standard architecture- reasonable efforts should be made to use standard, open architecture technologies and eliminate unnecessary technological diversity;

Interchangeability- whenever possible, all technology components should allow for the option of interchanging products from different vendors for functional, performance, or cost reasons with little or no disruption to the technology service;

Multifunctional workstations-intelligent, multifunctional workstations should be used as the primary means of delivering functionality to the end user, and systems should be designed to insure that workstations are connected to a network (wherever appropriate for the particular application) with secure communication linkages:

Standard interfaces- efforts should be made to require the design of applications to be modular and functional with standard interfaces so as to safeguard against incompatibility with third party users and information providers, and to allow flexibility and facilitate sharing of information with other government agencies, the securities industry and the investing public;

Off-the-shelf applications- reasonable efforts should be made to require the use of “off-the-shelf” applications as opposed to custom-developed systems whenever feasible and cost effective. Consideration should also be given to the use of open source software (OSS) whenever feasible; and

Technology available and supported in Bangladesh - all efforts should be made to assure that technologies selected for use by BSEC that are readily available and supported in Bangladesh, that products and services selected adhere to industry standards and have a useful life of five years or longer, and that the design and architecture of the systems selected support information (including data, text, image, sound and video) in standard formats.

3.1.1.3 Sustainability

Cost effectiveness, simplicity and user-friendliness will go a long way toward ensuring sustainability of BSEC's information and communications systems. Systems that are costly to maintain with ongoing licensing fees that are beyond the BSEC's financial resources may quickly become unsustainable. Given BSEC's and regulated entities' human and financial resource constraints, a strong case can be made to keep BSEC's

systems and processes as cost-effective, simple and user friendly as possible. Costly systems are less likely to be updated. Complex systems that are not user friendly are less likely to be used. As a result, such systems will quickly become ineffective/obsolete, and are more likely to be abandoned.

Applications should be simple and intuitive enough to be within the capacity of a middle level employee (at BSEC and regulated entities) to use without the need for specialized knowledge and extensive training. Design teams should seek to design solutions that work reliably, can be easily understood by users, and that are consistent with their current operating environments.

For example, most regulated entities are unlikely to have access to technical resources to comply with XBRL standards. Utilization of more sophisticated tools like XBRL can be planned for later stages on the ICT Roadmap.

3.1.2 Other Strategic Considerations

Advances in technology and the maturation of cloud computing provide a wide range software, hardware and systems architecture options that were not available only a few years ago. The options selected by BSEC could have a significant impact on the initial and recurring costs associated with its information systems. Some examples of the available options that would affect the initial and ongoing cost structure are:

Software licensing and delivery model – The traditional licensing/maintenance model is no longer the only option for the provision of software applications. Software applications are increasingly being provided under a Software-as-a-Service (SaaS) model which is typically hosted by the software vendor or a third party service provider.

Hardware and development/runtime environment delivery model – Advances in cloud computing also make it feasible for the hardware (servers, networking technology, firewalls, storage, and data center space) and development/runtime environments (operating systems, database and web server software, anti-virus/malware software, and virtualization technology to manage these resources) required to develop, maintain and run software applications to be acquired as a service (i.e. Infrastructure as a Service – IaaS - or Platform-as-a-Service - PaaS).

Cloud computing models have a number of advantages and some risks, and these would need to be weighed carefully in arriving at a decision in this regard. Among its key advantages are:

- Considerably lower initial costs (especially under the subscription pricing model for software) as applications can be accessed through “thin” clients, limiting hardware costs and IT resources;

- Mitigation of "obsolescence risk" as these delivery models typically guaranty upgrades to the latest hardware, operating systems and software versions;
- Service level agreements (SLAs) that guaranty high levels of uptime, regular/continuous data backups, and rapid recovery in the event of a disruption in services and/or disaster.

One of the key risks posed by cloud computing delivery models, that would need to be mitigated, is the risk of breaches in information security. This risk can be mitigated by the careful selection of providers that adhere to international standards and best practices for information security and are certified by third-party certification authorities (e.g. ISO/IEC).

3.2 ICT Roadmap

A 5 – 10 year *ICT Roadmap* should be developed that identifies:

- The key initiatives and information systems to be developed and deployed indicating sequencing and deployment timetables;
- Resources required for the implementation of strategic initiatives and the development and deployment of information and communication systems, and
- Staffing and skills development initiatives to support the ICT Strategy and Roadmap.

4 Current Requirements – Mission Critical Systems

While information and communications technology has advanced considerably since SECAS was implemented 15 years ago, BSEC's needs/requirements have not **fundamentally** changed. BSEC requires information and communication systems that can support the two broad spheres of its operations – i.e. **regulatory** and **administrative**. When The Aries Group undertook the task of assisting in the design and acquisition of SECAS in 1998-2000, there were no "off-the-shelf" applications that met BSEC's **regulatory** requirements. Today, although still quite limited in number, such applications do exist.

Below, we suggest a sequenced and phased approach for the deployment of the above mentioned mission critical systems and some fundamental principles for developing a deployment strategy and plan for them.

4.1 Key Objectives

We would suggest that the **principal objective** of the above mentioned mission critical information systems should be to:

- Enhance BSEC's effectiveness,
- Accelerate its business processes, and
- Improve its responsiveness

.... through better internal and external linkages and communications.

The following goals may also be considered:

- Enabling more accurate and rapid registration/licensing (and renewals) for regulated individuals and corporate entities;
- Improving off-site and on-site supervision and the oversight of exchanges, and providers of clearing, settlement depository services;
- Facilitating corporate notifications;
- Facilitating the introduction of risk based supervision (RBS) approaches such as risk profiling and risk based capital (RBC) requirements with appropriate financial monitoring;
- Reducing the time required to prepare data outputs and analysis;
- Facilitating the management and accelerating the disposition of enforcement cases and investigations;
- Facilitating and expediting the handling of inquiries and complaints;
- Enhancing BSEC's own financial management, HR and other support functions.

4.2 Mission Critical Information Systems – RIS & ERP

We would envision that BSEC's ICT Roadmap would include initiatives for the deployment of two mission critical systems - a *Regulatory Information System (RIS)* to facilitate/automate BSEC's regulatory functions, and an integrated *Enterprise Resource Planning (ERP)* system to facilitate/automate and modernize its administrative functions.

4.2.1 Regulatory Information System (RIS)

The RIS would, among other things, provide for electronic filing of "applications" (for various permissions/licenses, etc.) and "returns" (i.e. regulatory reporting requirements) by all of the regulated entities, and the analytical and business process automation tools that would allow BSEC to perform all of its regulatory functions and share relevant information within the organization. We have identified the following core requirements with respect to the RIS:

- Core databases of regulated entities (which includes firms, people, and instruments) all of which can be related to one another;
- A database for financial data for licensed entities and sub-entities (e.g. mutual funds);
- Database(s) for other structured and unstructured information;
- A licensing system to manage and cross connect regulated entities, people and instruments;
- A risk based regulatory assessment and monitoring system related to licensing, inspections and capital adequacy;
- A document collection and management system to link each document to one or more relevant entity, person or instrument;
- A set of analytical tools for the analysis of the data being collected from regulated entities;
- A report generator that can be used to rapidly and easily set up (and modify) standard and ad-hoc reports;
- A process/workflow management system that would allow a variety of workflows to be rapidly and easily built based on BSEC's current and evolving needs/requirements. This should include automated notices and reminders to the relevant internal staff (email) and/or regulated entities and people (email and hard copy);
- A case management system to record and track complaints, inspections and investigations involving entities, people and instruments;
- Fully searchable data exchange portals accessible from the BSEC website (which needs to be upgraded and integrated with the RIS) that allow:
 - Regulated entities (including listed companies, intermediaries, the exchanges, CDBL, licensed persons) to submit regulatory filings/returns (e.g. application for an IPO, periodic financial statements, short swing profit reports, etc.), and
 - BSEC to post laws, regulations, notices, and other communications/announcements of a regulatory nature.

4.2.2 Enterprise Resource Planning (ERP) System

The second broad need is for an Enterprise Resource Management/Planning (ERP) system, that would provide the required business process and office automation and communications tools - i.e. for the automation of accounting; human resource management; enterprise asset management; enterprise-wide email, file sharing, and

collaboration tools, etc. We have identified the following requirements for an ERP system:

- An accounting system for the automation of BSEC accounts;
- A full life-cycle human resource management system (HRMS) to maintain accurate and up-to-date employee records, including recruiting, hiring, onboarding, performance evaluations, disciplinary actions, education, training and skill development, etc.
- A payroll system that integrates with the accounting and HRM systems
- An efficient and modern email system;
- Basic office automation tools (i.e. word processing, spreadsheets, presentations, calendaring, collaboration, file storage and sharing tools);
- A document storage and management system that provides for storage of SEARCHABLE electronic documents (on metadata as well as document contents), rapid searching and retrieval of stored documents, and easy and rapid scanning of paper documents.

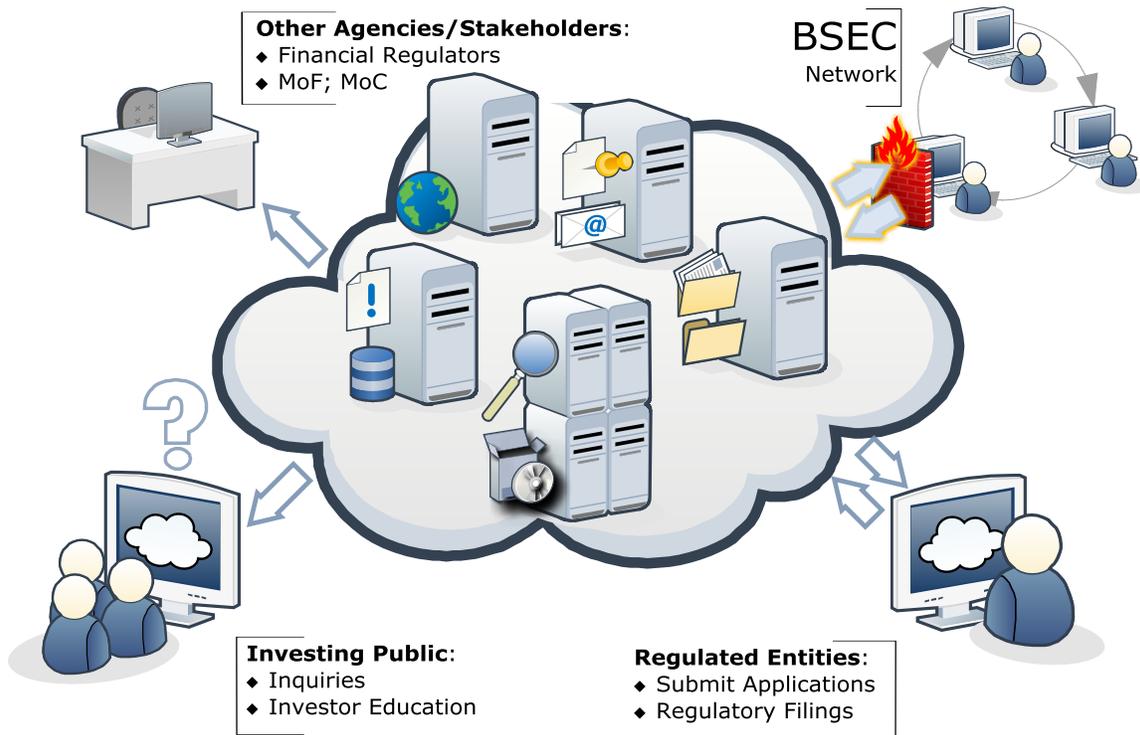
4.2.3 Integration, Linkages and Interfaces

Ideally, the above mentioned information systems would be integrated and linked in a manner that would facilitate BSEC's operations. Interfaces and linkages would include:

- Linkages between the RIS and Market Watch Surveillance System (MWSS) to enable more extensive and rigorous analysis of the information provided by the MWSS;
- Linkages between RIS and ERP such as:
 - Linkages to the HRM system - e.g to facilitate the efficient use of personnel and their assignment to various task forces/teams (i.e. for inspections, investigations, and enforcement cases); to maintain records of such assignments, etc;
 - Linkages to the accounting system - e.g. to record and report on fees associated with various regulatory filings, penalties, assessments, etc;
- As there are likely to be separate databases for document storage and management (i.e. one in each of the RIS and ERP systems), linkages between the two databases would also need to be developed.

The work on developing these linkages would need to be clearly spelled out and coordinated between the vendors for the RIS and ERP systems.

Figure 1 – BSEC Mission Critical Information Systems³



5 Sourcing - Mission Critical Systems

We are anticipating that the software for the two systems may be sourced from two different vendors. As there are not likely to be any vendors in Bangladesh that are qualified to provide a RIS (i.e. ones that can demonstrate prior experience in delivering a RIS for a financial regulatory authority), we expect the RIS would be sourced internationally. There are only a handful of providers internationally that specialize in providing RIS for financial regulators and that have actually delivered such systems.

We anticipate that the ERP may be sourced from a Bangladeshi provider as this type of system is broadly utilized by many enterprises in Bangladesh.

It is anticipated that the hardware may either be sourced from the same vendor supplying the ERP system, or from a separate local hardware vendor.

6 Initial Cost Projections – Mission Critical Systems

We have prepared (as reflected in Table 1 below) an estimation of the initial costs associated with the development/acquisition of the above referenced mission critical

³ This graphic depicts BSEC systems configured in accordance with one of the available options (cloud-based) for system architecture.

information systems (i.e. RIS and ERP systems). This projection is a “composite” based on information we have compiled over the course of a number of ICT projects for financial regulators in developing countries with similar characteristics to Bangladesh, and our inquiries and discussions with a number vendors/providers of these systems. Certain assumptions have been made (e.g. that the RIS will be acquired from a “best-of-breed” provider, and the ERP will be acquired from a local provider, and that the hardware required to run the systems will be located on BSEC premises and be managed and maintained by BSEC IT Department). To the extent that other alternatives are elected during the design phase, actual costs may vary considerably from these estimates.

It should also be noted that there will be recurring costs associated with the maintenance of the mission critical systems. There are too many unknown variables at this stage to allow for a reasonably accurate estimate of the recurring cost to be calculated at this time. Suffice to say that BSEC should expect to budget a sum equal to 20 – 30% of the initial costs to cover the recurring costs associated with these systems.

Table 1 - Estimate of Initial Costs for Mission Critical Information Systems

Software - Applications	
Regulatory Information Systems	1,000,000
ERP (i.e. HR, Accounts, etc.)	350,000
Total	1,350,000
Software - Servers & Databases	
Servers/databases (i.e. Windows/Web/SQL Server)	8,000
Server Antivirus	500
Total	8,500
Hardware	
Servers	9,000
Desktops	100,000
Networking hardware (routers, firewalls & switches, UPS)	15,000
Total	124,000
Grand Total	1,482,500

7 Approach – Next Steps

Below, we suggest a sequenced and phased approach for the design, acquisition and deployment of the above mentioned mission-critical information systems (RIS & ERP). ADB may wish to consider supporting BSEC in this initiative through a technical assistance (TA) project designed to support BSEC in developing specifications for the information systems/solutions, developing bidding documents, overseeing the bidding and selection process, monitoring the activities of the selected solution vendors, and advising the BSEC on addressing any problems encountered during the implementation

process. ADB may also wish to consider financing (in full or partly) the cost of these systems.

Considering BSEC's strategic objective of moving toward the adoption of risk a based approach to supervision (RBS), and the RBS initiatives spelled out in its Capital Markets Development Master Plan (CMDMP), it would be advisable to take advantage of this opportunity to also seek assistance in the development of a risk based supervision framework and model. This would allow for risk based approaches to be incorporated in the design of the RIS, which would greatly facilitate and accelerate the adoption of RBS approaches by BSEC.

Under the assumption that this approach is taken, the five phases (and related tasks) of the TA project might look similar to the following:

Phase 1 – Developing a Risk Based Supervision Model for the BSEC: Phase 1 activities would include analysis of the securities laws and regulations to identify overall informational requirements, including the jurisdictional scope of the BSEC and its public (outward-facing) and internal (inward-facing) information requirements and obligations. This would include interviews and surveys of: BSEC Commissioners and Executive Directors and market participants to determine present (and anticipated) practices of market participants (such as the stock exchanges, broker/dealers, merchant bankers, asset management companies and other regulated entities) to determine the types of information required to be exchanged between industry participants and the BSEC. Illustrative tasks would include:

Conducting a detailed due diligence of the current statutory objectives, strategy and operations of the BSEC, relevant government institutions, the Central Bank, the industry regulated by the BSEC, and the legal, regulatory and institutional framework.

Developing a RBRM that would allow the BSEC to achieve its regulatory objectives over the medium to long term. The RBRM should address the full cycle of risk identification, measurement, monitoring and mitigation/control, and should consider the level of development of Bangladesh's capital markets (its legal/regulatory framework and its institutions) and should strike a balance between managing risks and providing opportunities for the development of innovative instruments and services. A simple transplantation of existing models from other countries should be avoided. The RBRM (and the corresponding IT system), should be designed to flexibly adapt to changing needs and circumstances.

Supporting stakeholder consultations – to be led by the BSEC RBS Project Team - that includes all relevant stakeholders.

Recommending legal/regulatory revisions/amendments to facilitate/allow for the full implementation of RBS over the medium to long term, and proposing a time table for the introduction/adoption of these revisions/amendments.

Propose appropriate operational changes, including strategy, policy, business plan, organizational structure, and staffing that would enable BSEC to implement the risk based regulatory model over the above referenced time table.

Phase 2 – Requirements Analysis and Development of Applications and Technology Specifications:

Phase 2 is designed to produce a Requirements & Systems Analysis Report on which to base the development of a Request For Proposal (RFP)/Bidding Package. Phase 2 consists of information acquisition activities (interviews and questionnaires); an Information Systems Requirements Analysis, and formulation of the Systems Analysis Report. The central objective of Phase 2 is to examine the business processes employed and/or proposed by each department; identify those processes/procedures which are most conducive to automation; select the best method for automating these processes/procedures; and develop specifications for required applications on which to select an appropriate technology platform. In this process, consideration will need to be given to the advantages and disadvantages of following (among other) factors:

Software/applications strategies – Options to be considered include: develop or purchase; outright acquisition or software as a service (SaaS); best-of breed/off-the-shelf, or custom-developed;

Security of sensitive/confidential information - Mechanisms to be employed to guaranty the protection of private and confidential information from unauthorized use in all of the proposed applications.

Options for hosting – The advantages and disadvantages various hosting options, including: on-site (“data center”) self-hosting, off-premise (“cloud”) self-hosting, and third-party hosting.

Phase 3 - Developing Request(s) for Proposal/Bidding Package(s): Phase 3 would involve developing bidding documents for the development/acquisition of the information and communications technology (ICT) solutions required to support the BSEC’s regulatory and enterprise management activities. It also involves developing a list of interested and capable firms who are likely to bid on the systems development and implementation activity, and “prequalifying” these potential bidders.

Phase 4 – Assisting in the evaluation of Proposals/Bids, Selecting the Provider(s), and Negotiating Contract Terms: Phase 4 involves assisting and guiding BSEC’s Evaluation Committee in evaluating proposals/bids in accordance with predetermined evaluation

criteria; ranking the responding firms; selecting a vendor(s) and negotiating a contract(s). A key task is to develop a structured process for evaluating the responses (including the development of an evaluation checklist to ensure all critical factors are accounted for during the evaluation process) to the RFP(s) to ensure maximum objectivity and transparency in the evaluation process.

Phase 5 - Monitoring implementation, testing and training activities: Phase 5 involves monitoring the systems developers/vendors with respect to: delivery, installation and testing of hardware and software applications, training users and systems administration staff, conversion of data residing in legacy applications as required. Phase 4 will also include the review and assessment of the recovery plans/systems proposed by the systems developers/vendors to ensure they provide for recovery within an acceptable time frame following any disruptions.

APPENDIX 11

KEY PERSONS MET/INTERVIEWED

APPENDIX 11: Key Persons Met/Interviewed

Key Persons Met/Interviewed (May – July, 2014)

Company	Name	Position
1. Actis	Prabir Talati	Principal
2. Agrani Insurance Company, Ltd.	Sharif Mahmud	Company Secretary, EVP & Head of Admin.
3. Al-Arafah Islami Bank	Habibur Rahman	Managing Director
4. Al-Arafah Islami Bank	Mohammad Nadim, FCA	Chief Financial Officer
5. Asian Tiger Capital Partners	Sankor Chandra Paul	Associate Director Finance
6. Asset & Investment Management Services of Bangladesh, Ltd. (AIMS)	Yawer Sayeed	Managing Director & CEO
7. Atik Khaled & Co.	Gopal Chandra Ghosh FCA, FCMA	Director Consulting
8. Bangladesh Bank	Dr. Atiur Rahman	Governor
9. Bangladesh Bank	Glenn Tasky	Banking Supervisor Advisor
10. Bangladesh Bank	Akteruzzaman	Economic Advisor to Governor
11. Bangladesh Bank	Bishnu Pada Saha	General Manager, Debt Management Department
12. Bangladesh Bank	SK Sur Choudhury	Deputy Governor
13. Bangladesh Bank	Sudhir Chandra Das	Executive Director
14. Bangladesh Bank	Syeda Rezwana Begum	Deputy Director, Debt Management Department
15. Bangladesh Securities and Exchange Commission	Arif Khan, MBA CFA FCMA	Commissioner
16. Bangladesh Securities and Exchange Commission	Hon. Khairul Hossain	Chairman
17. Bangladesh Securities and Exchange Commission	Kamrul Anam Khan, ACMA	Director
18. Bangladesh Securities and Exchange Commission	Mahbulul Alam	Executive Director
19. BD Ventures	Mamun Rashid	Director
20. CDC	Craig Gifford	VP
21. Chittagong Stock Exchange, Ltd.	Dr. Muhammad Abdul Mazid	Chairman
22. Citi NA Bank	Shams Zaman	Director, Head of Corporate and Investment Banking
23. EFFAS-MSC	Chris Golden	Chairman
24. First Security Islami Bank	Ashraful Haque, FCA	First Vice President and CFO
25. Frontier Fund (Brummer& Partners)	Farhana Rahman	VP
26. Grant Thornton	Dewan Nurul Islam, MBA, FCA	Managing Director
27. Green Delta Insurance	Syed Forhad Abbas Hussain	Senior Executive Vice President
28. ICB Capital Management Ltd.	Md. Moshir Rahman	CEO
29. IDLC Finance Limited	Md. Saifuddin	Managing Director
30. IDLC Finance Limited	Selim R.F. Hussain	CEO & Managing Director
31. IDLC Investments Limited	Md. Moniruzzaman	Managing Director
32. Insurance Development & Regulatory Authority	M. Shefaque Ahmed	Chairman

Company	Name	Position
33. Insurance Development & Regulatory Authority	Sultan-ul-Abedine Molla	Member
34. Insurance Development & Regulatory Authority	Zuber Ahmed Khan	Member
35. Investment Corporation of Bangladesh	Hasina Akther	Deputy General Manager
36. Jiban Bima Corporation	Mahammad Sohrab Uddin PhD	Chairman, Board of Directors
37. KPMG, Rahram Rahman Huq Chartered Accountants	Abdul Hafiz Choudhury	Partner
38. LankaBangla	Nazimuddin Ahmed	Assistant Vice President
39. LankaBangla Finance	Mohammed Nasir Uddin Chowdhury	Managing Director
40. LankaBangla Securities	Mohammad Khairul Anam Chowdhury (Sohel)	Chief Operating Officer & Director
41. LankaBangla Securities Ltd.	Wali Ul Islam	CEO & Director
42. Mercantile Bank Limited	Jahangir Javed	Vice President & Head of Treasury
43. MetLife Alico	Shah Mohammad Mushfiqur Rahman	Senior Assistant Manager, Legal
44. MetLife Alico	Syed Hammadul Karim	Deputy General Manager
45. Ministry of Finance	Mohammad Muslim Chowdhury	Director Public Financial Systems
46. Ministry of Finance	Kahir	Finance Secretary
47. Ministry of Finance	Nazmus Sakib	Additional Secretary
48. Ministry of Finance, Finance Division	AF Amin Choudhury	Joint Secretary
49. Ministry of Finance, Office of the Controller General of Accountants	Jiban Krishna Chowdhury	Addl. CGA (Accounts & Procedure)
50. Ministry of Finance, SPEMP	Mohammad Muslim Chowdhury	Director(Additional Secretary), Public Financial System
51. MTB Capital Limited	Khairul Bashar AT Mohammed	CEO
52. MTB Securities Limited	MD Nazrul Islam Mazumder	Chief Executive Officer
53. Mutual Trust Bank Ltd.	Md. Anower Parvez	First Assistant Vice President & Senior Dealer Treasury Department
54. National Bank Limited	Abdus Sobhan Khan	Senior Executive Vice President & Head of Treasury
55. National Credit and Commerce Bank, Ltd.	Ashim Kumar Saha	Executive Vice President & Head of Treasury
56. National Credit and Commerce Bank, Ltd.	Kamonasish Saha	Principal Officer
57. Osiris	Jason Bajaj	Co-Founder/COO
58. Policy Research Institute of Bangladesh	Mr. Ahsan Mansur	Executive Director
59. Prime Bank Limited	MD. Masud Shahjahan	Vice President & Deputy Insurer
60. Prime Insurance Company Limited	Rehana Akter Ruma	Senior Assistant Vice President, Head of Human Resource Development
61. Pubali Bank Limited	Helal Ahmed Chowdhury	Managing Director & CEO
62. Sabinco	Md Minhaz Zia	Ex CEO
63. SEAF	Fahim Ahmed	Senior VP
64. Southeast Bank Limited	MD Jahangir Kabir	Assistant Vice President & Head of Treasury

Company	Name	Position
65. Southeast Bank Limited, Treasury Division	MD Kazi Mukhtakin	Principal Officer
66. The Institute of Chartered Accountants of Bangladesh	Kamrul Abedin, FCA	Vice President (T&R)
67. The Institute of Chartered Accountants of Bangladesh	Mahbub Ahmed Siddique, FCA	Director (Technical)
68. The Institute of Chartered Accountants of Bangladesh	Md. Saiful Islam, ACA	Senior Deputy Islam ACA Professional Conduct
69. The Institute of Chartered Accounts of Bangladesh	AKM Rahmat Ullah FCA	Secretary
70. Union Bank	M. Abdul Hannan Khan	SVP & Company Secretary
71. Union Bank	Mr. Md. Abdul Hamid Miah	Managing Director
72. Union Capital Limited	Md. Akter H. Sannamat FCA, FCS	Managing Director & CEO
73. Union Capital Ltd.	Md Akter H Sannamat, FCA, FCS	Managing Director & CEO
74. Uttara Bank Limited, Treasury Division	BM Kamal Uddin	Senior Principal Officer
75. Venture Investment Partners Bangladesh	Dr Zia Ahmed	Chairman
76. VIPB Asset Management Company, Ltd.	Shahidul Islam	Chief Executive Officer

Key Persons Met/Interviewed (Aug – Nov, 2014)

Company	Name	Position
1. BSEC	Prof. Dr. Khairul Hossein	Chairman
2. BSEC	Saifur Rahman	P.D.
3. BSEC	E.D. Mahbubul Alam	Lic. & Sup./CID
4. BSEC	Arif Khan	Commissioner
5. BSEC	Md. Manowar Hossain	Chief Accountant
6. IDRA	M. Shefaque Ahmed	Chairman
7. IDRA	Sultan-al-Abedine Molla	Member
8. IDRA	Zuber Ahmad Khan	Member
9. IDRA	Md. Quddus Khan	Member
10. MetLife ALICO	Md. Nurul Islam	Regional SVP
11. Progressive Life Insurance Co, Ltd	M A Karim	Managing Director
12. Reliance Insurance Ltd	Akhtar Ahmed	Adviser
13. Pragati Life Insurance Ltd	M J Azim	
14. Meghna Life Insurance Co Ltd	Nizam Uddin Ahmed	Chariman
15. Green Delta Insurance	Farzana Chowdhury	Managing Director & CEO
16. Bangladesh Insurance Academy	S M Ibrahim Hossain	Chief Faculty Member
17. Bangladesh Insurance Association	Sheikh Kabir Hossain	President
18. BIA	Mollah Md. Nurul Islam	Secretary General
19. BIA	Enamul Haque Khan	Deputy Secretary

Company	Name	Position
20. Karnaphuli Insurance Company	Nasir Uddin Ahmed	Vice Chairman
21. Prime Islami Life Insurance, Ltd	K M Mortuza Ali	Managing Director
22. BICM	Md. Abdul Hannan Zoarder, E.P.	Managing Director
23. BICM	S.M. Rafiqul Islam (Ripon)	
24. BICM	Hassan Kabir	Librarian
25. BSEC	Anwarul Islam	ED, SRMIC & Corporate Finance
26. SRMIC	Mohammed Shaiful Azam	Director
27. BSEC	Md. Moinur Rahman	Director
28. BSEC	Kamrul Anam Khan	Director
29. BSEC	M. Hasan Mahmud	Executive Director, Mutual Funds & SPVs
30. BSEC	Farhad Ahmed	Executive Director Enforcement, Administration, Finance and International Relations
31. BSEC	Farhana Faruqui	Director
32. BSEC	Ashraful Islam	Executive Director, MIS & Research
33. BSEC	Md. A. Salam Sikder	Commissioner
34. BSEC	Prof. Md. Helal Uddin Nizami	Commissioner
35.	Md. Amzad Hussain	Commissioner
36. ADB/BRM	Bidyut Kumar Saha	Sr. Project Officer
37. DSE	A.K.M. Ziaul Hasan Khan	Chief Regulatory Officer
38. DSE	Prof. Swapan Kumar Bala	Managing Director
39. Emerging Credit Rating Ltd.	Dr. Jamaluddin Ahmed	Managing Director
40. Independent Barrister	Sheela Rahman, Esq.	Independent
41. Mona Financial Consultancy & Securities, Ltd.	Ahasan Islam Titu	Managing Director Also Associate VP, Sandhani Life Insurance Co.
42. Beta One	Wali-ul Maroof Matin	Executive Vice President
43. CSE	Dr. Muhammad Abdul Mazid	Chairman
44. CSE	Syed Sajid Husain	Managing Director
45. CSE	Ahmad Dawood	Chief Regulatory Officer
46. CSE	Md. Ghulam Faruque	Deputy General Manager, Dhaka Office
47. NBR	Md. Abdul Rahman Khan	Additional Commissioner of Taxes & First Secretary, Tax Policy
48. IDLC	Md. Moniruzzaman	Managing Director
49. IDLC	Rajib Kumar Dey	Head of Proprietary Desk
50. Syed, Ishfaq, Ahmed & Assoc.	Sayed Afzal Hasan Uddin	Barrister
51. LankaBangla Securities	Md. Mahfuzur Rahman	Research In-Charge
52. LankaBangla Securities	Gazi Mohammed Tareq	Assistant General Manager
53. LankaBangla Securities	S.A.R. Md. Muinul Islam	PRINCE2 Practitioner
54. LankaBangla Securities	Md. Ashaduzzaman Riadh	Strategic Portfolio Manager
55. LankaBangla Securities	Rehan Muhammad	Head of Institutional & Foreign Trade
56. Rahman, Rahman Huq (KPMG)	Ali Ashfaq	Partner
57. Rahman, Rahman Huq (KPMG)	Khalid Rahim,	Senior Consultant

Company	Name	Position
58. Rahman, Rahamn Huq (KPMG)	Syed Aliul Ahabab	Manager Audit & Advisory Services
59. Investment Corporation of Bangladesh (ICB)	Md. Fayekuzzaman	Managing Director Also President, Association of Asset Management Companies (AAMC)
60. ICB Capital Management Co. Ltd.	Md. Moshir Rahman	CEO
61. ICB Securities Trading Co. Ltd.	Jubaidur Nasrin	CEO
62. ICB Asset Management Co. Ltd.	Md. Alauddin Khan	CEO
63. Race Mgmt., PCL	Hasan Imam (Also Secretary, AAMC)	CEO and Managing Director
64. Bangladesh Bank	S.K. Sur Chowdhury	Deputy Governor
65. IMF	Stella Kaendera	Resident Representative
66. AIMS AMC	Yawer Sayeed	Managing Director
67. Independent	Zubaidur Rahman Former World Bank Auditing & Accounting ROSC Expert	Independent
68. MoF	Md. Mamun-Al-Rashid	Joint Secretary
69. MoF	Tapan Kumar Karmaker	Additional Secretary
70. MoF	Mohammad Muslim Chowdhury	Additional Secretary
71. MoF	Mohd. Rasheedul Amin	Senior Assistant Secretary
72. MoF	Dr. M. Aslam Alam, Secretary	Bank & Financial Institutions Division
73. MoF	Arjit Chowdhury	Joint Secretary
74. MoF	Newaz Hossain Chowdhury	Sr. Asst. Secretary
75. VIPB Asset Management Co.	Shahidul Islam, CFA	Chief Executive Officer
76. BRAC EPL Investments Limited	Muhammad A. (Rumeel) Ali	
77. BRAC EPL Investments Limited	Khaled Yusuf Farazi	CEO
78. LR Global Partners	Reaz Islam	Managing Partner
79. Syed Ishtiaq Ahmed & Associates	Syed Afzal Hasan Uddin	Barrister

APPENDIX 12

FEEDBACK/COMMENTS RECEIVED FROM THE INTER-AGENCY
ADVISORY GROUP (IAAG) ON DRAFT FINAL REPORT

Decision of Inter Agency Advisory Group (IAAG) relating to comment/opinion of Bangladesh SEC, National Board of Revenue, Bangladesh Bank and Insurance Development Regulatory Authority on Draft Final Report of Capital Market Development Program (CMDP)-III (TA-8512BAN) submitted by The Aries Group, Ltd.

Sl. 1	Name of the Institute 2	Content or reference number of the content (on which comment/opinion has been made) 3	Comment/opinion 4	Decision of Inter Agency Advisory Group (IAAG)	Response
1	Bangladesh Securities & Exchange Commission	<p>2.1.1.2 Information and Communications Technology (ICT) Initiative (Para 1, Page 4)</p> <p>BSEC's use of ICT is presently at a very low level. Fundamental information and communications technologies and systems that are commonly utilized by the private sector (including entities BSEC oversees) are not utilized at the expected level.</p>	<p>2.1.1.2 Information and Communications Technology (ICT) Initiative (Para 1, Page 4)</p> <p>BSEC's use of ICT is presently not at an expected level. BSEC is yet to utilize the fundamental information and communications technologies and systems that are commonly utilized by the private sector (including entities BSEC oversees).</p>	IAAG accepted the opinion of BSEC.	This comment has been reflected Page 4 of the first (overview) section of Final Report in Section 2.1.1.2
2		<p>2.1.1.4 Office of Internal Control & Compliance (OICC) (Para 2, Page 5)</p> <p>As mentioned above, one of the key tasks ahead for BSEC is to restore the confidence of the investing community in the integrity of the markets. In so doing, BSEC must, itself, be beyond reproach. The present leadership of BSEC has done a remarkable job of restoring the integrity of BSEC. Looking to the future, to guard against a recurrence of the unfortunate incidents leading up to the replacement of the senior level BSEC officials in 2011, we suggest BSEC consider establishing an Office of Internal Control and Compliance (OICC) as a separate department.</p> <p>As a related measure and a step that can be taken immediately with donor assistance, we may also suggest a Vulnerability Assessment (VA) of BSEC be undertaken by an independent third party. The primary purpose of such an assessment would be to improve BSEC's ability to detect and prevent internal misconduct. The impact of such an exercise on market confidence could be significant as it would signal to the market and general public BSEC's dedication to improving its own integrity and reputation and set an example for market participants. The VA would recommend measures to address weaknesses and establish ongoing programs to detect prevent them.</p>	<p>2.1.1.4 Office of Internal Control & Compliance (OICC) (Para 2, Page 5)</p> <p>As mentioned above, one of the key tasks ahead for BSEC is to restore the confidence of the investing community in the integrity of the markets. In so doing, BSEC must, itself, be beyond reproach. The present leadership of BSEC has done a remarkable job of restoring the integrity of BSEC. Looking to the future, to guard against a recurrence of the unfortunate incidents leading up to the replacement of the senior level BSEC officials in 2011, we suggest BSEC consider establishing an Office of Internal Control and Compliance (OICC) as a separate department.</p> <p>The Commission has already initiated the process of establishing an office of Internal Control & Compliance Department.</p> <p>The Commission does not agree with the concept of Vulnerability Assessment, since such concept does not exist in any Commission or Regulatory Agency in Bangladesh. Hence, the second Para of draft final report (as mentioned in column 4) needs to be omitted.</p>	<p>It is decided in the IAAG meeting that the following Para may be accepted:</p> <p>As mentioned above, one of the key tasks ahead for BSEC is to restore the confidence of the investing community in the integrity of the markets. In so doing, BSEC must, itself, be beyond reproach. The present leadership of BSEC has done a remarkable job of restoring the integrity of BSEC. Looking to the future, to guard against a recurrence of the unfortunate incidents leading up to the replacement of the senior level BSEC officials in 2011, we suggest BSEC consider establishing an Office of Internal Control and Compliance (OICC) as a separate department.</p> <p>An assessment of scope of work of Internal Control and Compliance department may be undertaken independently.</p>	This comment has been reflected Page 5 of the first (overview) section of Final Report in Section 2.1.1.4

Sl. 1	Name of the Institute 2	Content or reference number of the content (on which comment/opinion has been made) 3	Comment/opinion 4	Decision of Inter Agency Advisory Group (IAAG)	Response
3	Bangladesh Bank	<p>Policy Action 1- Issuance to deepen Benchmarks</p> <p>It is encouraging that Bangladesh Bank has recognized the importance of improving the liquidity in key benchmarks as a key factor in establishing an effective meaningful government benchmark. It is noteworthy that BB has been reissuing 10 year bonds since 2013. In that case a particular amount of bond is issued having the same ISIN. We also recommend that all tenors of 5-year and upwards maintain the same ISIN in tap and for either quarterly auction or syndication until a pre-announced amount has been issued. We recommend that infrastructure be put in place to support the existence of a “when issued” market. As a minimum this infrastructure amounts only to the ability to trade for a future settlement date. Given the informational value of such trading a summary report of all such trading activity should be compiled. Each sale of new stock, whether by auction or syndication, should include the existence of a when issued market for at least one week prior to the sale.</p>	<p>Bangladesh Bank has been reissuing 10 year bonds since 2013 and 15 and 20-year bonds since 2014. In that case a particular amount of bond is issued having the same ISIN. The practice of monthly issuance is appropriate in our current conditions of market liquidity; the same objectives of using new ISIN after attainment of critical volume of the earlier one can be achieved with the current practice as with quarterly issuance.</p> <p>Our bond market has not attained sufficient depth yet to consider introduction of such short selling practices (when-issued), which cause problems even in deeper, broader markets.</p>	IAAG accepted the opinion of Bangladesh Bank.	This comment has been reflected on Page 24 of Appendix 3 (Bond Market Development) of the Final Report under the heading Policy Action 1 – Issuance to deepen benchmarks.
4	National Board of Revenue	<p>Appendix 3 of 1.8.4 Tax Benefit of Mutual Fund Investors / Unit Holders:</p> <p>To stimulate the growth of fixed income mutual funds, a measure that could be considered is to provide a higher tax exemption on interest income to unit holders of fixed income mutual funds.</p>	There is no scope to provide a higher tax exemption on interest income of fixed income mutual funds than Equity Mutual Fund.	IAAG recommended that NBR may enhance the exemption limit in the next budget.	This comment has been reflected on Page 21 of Appendix 3 (Bond Market Development) of the Final Report in Section 1.8.4
5	National Board of Revenue	<p>Appendix 9 of 5.4 Recommendations regarding Tax Issues</p> <p>Given the nature of such a Sukuk which involves transfer of assets, stamp duty laws need to be reviewed to avoid creating a disincentive to establish such mechanism. We would note that for other asset backed securitizations, other than Sukuk issuance, there are precedents where Stamp Duty has been waived. Given that this structure is effectively a pass through, it is important to ensure Stamp Duty, and indeed other forms of tax, is exempted to make such Sukuk issuance is financially viable.</p>	Since, Sukuk is still not in operation, NBR makes no comments on the matter related to tax exemption on income generated from Sukuk.	IAAG accepted the opinion of National Board of Revenue.	This comment has been reflected on Page 16 of Appendix 9 (Promotion of Sukuk in Bangladesh) of the Final Report in Section 5.4

Sl. 1	Name of the Institute 2	Content or reference number of the content (on which comment/opinion has been made) 3	Comment/opinion 4	Decision of Inter Agency Advisory Group (IAAG)	Response
6	Insurance Development & Regulatory Authority (IDRA)	<p>Appendix 4 of 1.3 Third Phase</p> <p>We proposed that at this point, full privatization of JBC and SBC should be considered, if this appears to be appropriate at that time.</p>	<p>“Full Privatization” may be replaced by “Full Commercialization or Corporatization”</p>	<p>IAAG agreed that JBC and SBC have been corporatized, so the comment (column-3) of full Privatization should be deleted.</p>	<p>This comment has been reflected on Page 4 of Appendix 9 (The Insurance Industry) of the Final Report in Section 1.3</p>
7		<p>Appendix 4 of 3.1 Enhancing IDRA's Operational Effectiveness</p>	<p>In para-3, page-7 following line may be added “Like BSEC, BTRC, Insurance Development and Regulatory Authority may be renamed by Bangladesh Insurance Development and Regulatory Commission (BIDRC)</p>	<p>IAAG disagreed that IDRA's proposal is not implementable at this point of time.</p>	<p>This comment has been reflected on Page 7 of Appendix 9 (The Insurance Industry) of the Final Report in Section 3.1</p>
8		<p>Appendix 4 of 3.2 Other Areas Requiring Legislative Action</p> <p>Amending Section 17 of the Insurance Act to provide a "sunset clause" that phases out the Central Rating Committee (CRC) within 5 years (or by 2020).7</p>	<p>We think, Amending Section 17 of the Insurance Act to provide 'sunset clause' that phases out the Central Rating Committee (CRC) within 5 years (or by 2020) will not be a rational decision. Amendment may be like this “Amending Section 17 of the Insurance ACT to provide for a yearly review of the usefulness of CRC IDRA and take appropriate measure to phase out CRC “IDRA may be given authority to delist insurance policy requiring CRC approval phase by phase.</p>	<p>IAAG agreed that the comment (column-3) of the draft report should be deleted.</p>	<p>This comment has been reflected on Page 11 of Appendix 9 (The Insurance Industry) of the Final Report in Section 3.2</p>
9		<p>Appendix 4 of 3.2 Other Areas Requiring Legislative Action</p> <p>Amending the Insurance Act to repeal the maximum commissions and maximum expenses provisions (sections 58 & 62). Recognizing that it may indeed be necessary to cap commissions and expenses in the short run, we propose addressing these limits through regulation that may also include a sunset clause that phases out these limits over a reasonable time frame. Ultimately, these should be market-driven.8 Permitting lower cost distribution channels, such as bancassurance and direct marketing, will be a more effective approach to reducing costs than legislated maxima, which appear to be ineffective in any event</p>	<p>We think the proposed amendment of section 58 and 62 of the Insurance Act for a “sunset clause” will not be rational. IDRA may be empowered to review these sections (58, 62) regarding maximum commission and expense limits respectively. The review may be held annually and applicability of section 58 and section 62 may be reviewed with respect to performance of companies and decision may be taken on market analysis, regarding time limit of these sections.</p>	<p>IAAG accepted that IDRA's proposal is not implementable at this point of time.</p>	<p>This comment has been reflected on Page 12 of Appendix 9 (The Insurance Industry) of the Final Report also in Section 3.2</p>