Second Capital Market Development Program

Impact and Results Assessment

September 2014

Asian Development Bank

Executive Summary

This note presents a summary of reforms in the capital markets undertaken by the Government of Bangladesh with a view to highlighting key results. Bangladesh has made very significant strides towards strengthening capital markets as set out in its capital market master plan. Through a strong partnership between Government and ADB, reforms have been rolled out, and the market is building increasing confidence as the new policies and regulatory incentives under the ongoing Second Capital Market Development Program (CMDP 2) gain traction. The CMDP 2 addresses structural deficiencies in Bangladesh's capital markets by deregulating the financial system to better support the real economy by promoting private sector investment, and boosting economic growth. The CMDP 2 was based on a two-track approach that sought to put firewalls in place to support market stabilization following on the 2010 stock market debacle while planting the seeds for key reforms leading to sustainable market development. Developing stable, resilient financial markets is not a goal on its own but rather a process that can support development and growth in an economy. A follow-up operation is proposed under the Third Capital Market Development Program (planned for the first quarter of 2015) to enhance the sustainability of structural reforms under CMDP 2.

I. Background - Stock Market Debacle of December 2010

1. Bangladesh's stock markets have been characterized by large volatility with recurrent periods of boom and bust that have represented a destabilizing force for the economy. Following a bull run during most of 2010, the main Dhaka index fell by about a half from its December 2010 all-time high corresponding to a loss of about 22% of gross domestic product (GDP) as of October 2012. The market correction wiped out $27 billion in market capitalization and with it bankruptcies, savings, and jobs, triggering a wave of social discontent. The ensuing liquidity crunch led to heightened solvency risks. Indeed, given the interconnectedness between banks and equity markets, there was a grave concern that a perfect storm could result in a negative feedback loop from the financial sector to the real economy and potentially bringing the economy to a grinding halt.

2. Following the market debacle, a high-level probe was established by the Government of Bangladesh in 2011 to examine the deficiencies that led to the crash. The high-level probe also highlighted limited enforcement of regulation by the Bangladesh Securities and Exchange Commission (BSEC) and commercial banks' excessive investment in stock markets.

3. The December 2010 episode reflected the vulnerable state of Bangladesh's capital market and represented a convergence of factors that undermined sustainable development. A critical problem was a sense of excessive government tutelage over the capital markets, which held back sector development and constrained responsible institutions from fully carrying out their mandates effectively. This combined with strong vested interest resulted in an entrenched status quo.

4. Despite the large financing needs of the economy, Bangladesh's capital markets had not been particularly effective in channeling savings to support investment and growth. Bank credit often ended up pursuing speculative initiatives and fuelling the stock market boom which following bull runs proved unsustainable and leading to sharp market corrections. An analysis by ADB of the December 2010 episode traced the proximate factors behind the boom and bust cycles to strained supervisory capacity and oversight by the BSEC, lax and excessive reliance on margin lending requirements, unreliable financial reporting standards, and weak coordination across financial regulators. Weak investor confidence prevailed in the capital markets and, therefore, limited demand for equities and bonds. Lax regulatory enforcement of the BSEC, lack of adjudication of securities cases (all securities cases of the 1996 crash are still pending), poor corporate governance, as well as weak governance and operation of the stock exchanges further contributed to the state of the capital markets. From a structural perspective, a lack of sustainable long-term infrastructure financing options also persisted in the economy because of limited capital market development.

II. Growth Imperative and Infrastructure Challenge

5. For Bangladesh to increase its GDP growth and attain its annual target of 10% by FY2021, it will have to develop an enabling policy and institutional framework that targets (i) financial markets stabilization following the history of booms and busts as well as (ii) sustainable capital market growth through liberalizing investment decisions, removing distortions, and promoting stronger supervision and governance of the markets. Correcting the existing legal and regulatory framework, continuing improvements to the market infrastructure (stock market surveillance system), and empowering institutions (e.g., the BSEC) by reducing government tutelage are crucial to develop a more stable and resilient financial system.

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

III. CMDP 2 Design

7. The CMDP 2 supports the Government's reforms and comprises (i) a program loan of $300 million to support vital capital market reforms, and (ii) an associated technical assistance (TA) grant of $750,000 to facilitate implementation of key reform actions under the program.[1] The objective of the CMDP 2 is to stabilize the financial markets and facilitate sustainable growth by (i) strengthening market stability by enhancing the role of the BSEC to develop the market, promoting financial stability through joint supervision of the financial system, strengthening regulatory measures, and developing a market surveillance system; (ii) enhancing market facilitation by developing a long-term vision for capital markets, upgrading accounting and auditing standards, expediting adjudication of enforcement actions, improving governance of listed companies, and pursuing demutualization of the stock exchanges; (iii) enhancing supply measures by incentivizing the issuance of equities and bonds; and (iv) enhancing demand measures by developing liquid bond markets and catalyzing institutional investor demand.

8. Major lessons that were reflected in the design of CMDP 2 were as follows: (i) a comprehensive reform program can be feasible only if it is an integral part of a government-owned long-term development strategy[2] and if there is ownership at the highest levels of government and the private sector; (ii) the number of program measures should be limited so that ADB can monitor compliance with them throughout the program; and (iii) there should be adequate consultation with private and public sector stakeholders while forming capital market reform programs. In line with key recommendations of both evaluation studies, the efficiency and effectiveness of the CMDP 2 was facilitated by (i) a limited number of policy actions to monitor program compliance effectively, (ii) the formulation of a long-term national capital market master plan, and (iii) a comprehensive consultation with stakeholders through numerous national workshops to effectively diagnose the issues led to a strong and relevant proposed policy matrix.[3]

---

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

[2] A Third Capital Market Development Program has been included in ADB's country partnership strategy 2011–2015 for 2015 that will seek to deepen reforms initiated under the Second Capital Market Development Program.

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

IV. CMDP 2 Results

9. As is well known in the evaluation literature, the outcome and impact of any market reform process are unlikely to be noticeable over the short term. In this section, we present some of the results of the program and analyze in the next section some key market indicators. The CMDP 2 addressed structural deficiencies in the capital markets by deregulating the financial system to better support the real economy, promote private sector investment, and boost economic growth. The CMDP 2 was based on a two-track approach that sought to put firewalls in place to support market stabilization following on the 2010 stock market debacle while planting the seeds for key reforms leading to balanced, resilient and sustainable market development. The program was based on three important pillars. **First, the BSEC was to be given a stronger mandate, together with resources**. The operational and financial efficiency of the BSEC was enhanced by (i) allowing unhindered access to the BSEC Fund, (ii) removing government approval of the BSEC budget or expenditures from the BSEC Fund, and (iii) providing benefits to BSEC staff comparable to those at Bangladesh Bank. That allowed the BSEC to enable a reformed regulatory partnership that defined the proper roles of the various classes of participants and ensured that each participant would carry out its responsibilities under the program.

10. The introduction of a real-time state-of-the-art market surveillance system at the BSEC directly addressed one of the key impediments to Bangladesh's capital market development by detecting the kind of trading irregularities and market abuses that had led to the stock market crisis of 2010. The enforcement capacity by BSEC was significantly enhanced through the creation of a capital market tribunal to expedite resolution of securities cases pending in the court system in Bangladesh. Approximately 366 BSEC cases are pending with various courts, which include 15 cases brought as a result of the stock market crisis of 1996. The BSEC is establishing high international standards of accounting and auditing to ensure the quality and reliability of filed financial information. The appointed chief accountant with international credentials has designed guidelines for empanelling auditors and established an accredited list of auditors qualified in accordance with those standards. The enactment of the FRA will play an integral role in upgrading the accounting and auditing standards to enhance market confidence. The enactment would be followed by the establishment of an independent Financial Reporting Council that would adopt International Accounting Standards and International Standards of Auditing for the concerned entities, as well as to monitor and enforce them, and possess the authority to license auditors and accountants. Implementation of this pending critical reform will lead to the successful completion of CMDP 2. The effective implementation of structural reforms to enhance BSEC's mandate was realized by the strong collaboration between BSEC and Ministry of Finance as well as their focused determination to provide a win-win situation to strengthen the financial system and better support the real economy.

11. **Second, stock exchanges were identified as critical drivers of change.** The agreed approach was to correct the governance structure through demutualization of the Dhaka and Chittagong stock exchanges. This served to align the broader incentives of market development with those of what might be termed the "members of the club," mainly the brokers and dealers. By strengthening market governance in capital markets, the CMDP 2 enhanced market efficiency and transparency, as well as improved investor protection. The timely and effective completion of the demutualization process at the stock exchanges represented another key milestone of the program in countering strong vested interest and challenging the status quo. The brokers and dealers have historically resisted any reforms that could reduce their control over the stock exchanges. Demutualization of the stock exchanges has segregated ownership, management, and trading rights of members and converted the two exchanges into commercial

and more professionally run organizations while enabling them to pursue their strategic interests, including market development, with more vigor. A governance structure representing all stakeholders and encouraging competition among trading members is helping to develop the country's capital market and attract new investors. The exchanges are now less susceptible to members' vested interests. The demutualization will also facilitate the development of crucial new technology infrastructure through alternative methods of raising capital (such as the entry of a strategic investor into both stock exchanges by June 2017). Numerous steps have been taken to effectively implement and conclude the demutualization process, such as enactment of the Demutualization Act in April 2013, followed by submission of the demutualization schemes by both stock exchanges (i.e., operational plans), and the approval of these schemes by the BSEC in September 2013. The dedicated efforts of the BSEC and the stock exchanges ensured successful implementation of these demutualization reforms.

12. **Finally, bond markets had to be promoted to mobilize much-needed long-term financing.** By addressing policy and regulatory constraints upon the issuance of corporate securities, the CMDP 2 is helping to increase the number of bond and equity issues, both primary and secondary. This should facilitate mobilization of scarce financial resources for productive long-term private sector investment and employment generation by addressing the major development challenge of financing the economy's looming infrastructure gap. The corporate bond market is being catalyzed by implementing a fast-track regulatory process for private placements that balances investor protection with the ease of approval. To develop a more liquid bond market and reliable yield curve, the CMDP 2 supported reform of the primary dealer system through fostering a more efficient price discovery mechanism in auctioning government securities. This entailed the government being a price-taker by issuing treasury bills and bonds at market rates. The operating framework of the primary dealer system has seen improvements in the promotion of competitive bidding that has served to improve overall liquidity management. Consequently, devolvement or lowest price bidding has absorbed a smaller proportion of allocated issuance than prior to the CMDP 2. A strategy of creating liquid benchmark issues is also being pursued by reducing the number of issues and increasing the average size of issues by re-opening existing issues. The initial focus is on smaller tenors since these are easier for the market to price. Longer tenors are being developed as the market matures with the enhanced role of institutional investors such as the insurance sector. The bond market reforms were accomplished by the Government's dedicated efforts and strong collaboration amongst BSEC, Ministry of Finance, and Bangladesh Bank.

13. The CMDP 2 also significantly reduced tax distortions in the capital markets through implementing broad and substantive tax policy actions that ranged from ensuring a level playing field for mutual funds to promoting bond market activity and encouraging the use of equity financing. In line with international best practices, the initial public offering tax was eliminated to spur the supply of equities by creating an incentive to use equity financing. Bonds were exempted from transaction taxes which removed an important deterrent to secondary bond market trading, thereby triggering bond market activity and enhancing the supply of bonds. Tax distortions were removed to catalyze the market in asset-backed securities, as well as to create an even playing field between Investment Corporation of Bangladesh funds and the rest of the mutual fund industry. The implementation of such groundbreaking tax policy reforms were made possible by the perseverance of the Ministry of Finance and the National Board of Revenue.

14. On the institutional investor side, the CMDP 2 focused on enhancing insurance industry participation in the capital market by introducing measures to promote the industry's growth and stability, such as compliance with the minimum capital requirements of the Insurance Act of 2010, and encouraging investor demand through the Insurance Development and Regulatory

Authority (IDRA's) issuing investment guidelines. The white paper (renamed the Government's national insurance policy paper) was formulated in November 2012 and encapsulates measures to promote the insurance industry. The policy paper was approved by the cabinet in June 2014. Implementation of the policy paper was initiated in July 2014. The insurance regulations regarding CEO appointment and management of the IDRA Fund are being implemented since January 2013. From January 2013 to June 2014, CEOs were appointed across numerous insurance companies as per these guidelines. The IDRA staff are paid their salaries and benefits from the IDRA Fund as per IDRA Fund guidelines. The effective coordination and cooperation between the Ministry of Finance and IDRA ensured the carrying out of these integral reforms to promote the insurance industry.

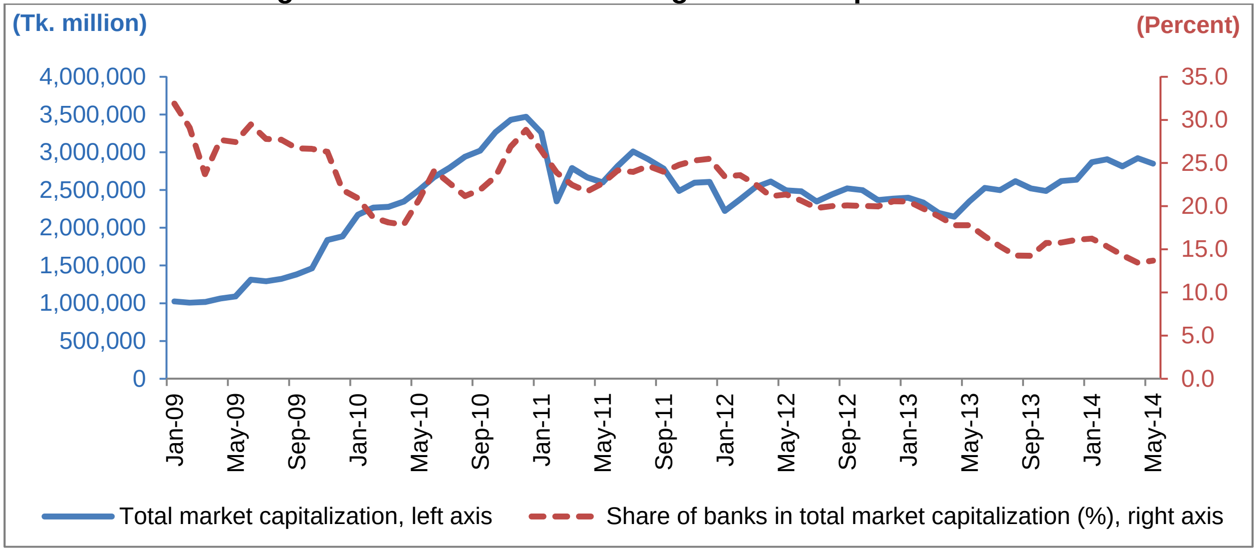
15. Under CMDP 2, financial stability was enhanced through improved coordination amongst regulators by making the council of financial regulatory agencies an effective body for financial sector oversight. The council, which includes all the agencies with mandates for financial stability and financial sector oversight—Bangladesh Bank, the BSEC, the IDRA, and the Ministry of Finance, adopted a specific mandate to include (i) macro-prudential oversight of the financial system and contingency planning, (ii) a forum for the review of financial sector policy issues and the identification of needed amendments to the legal and regulatory framework, and (iii) a high-level forum for coordination and information sharing for the purposes of consolidated supervision. However, in practice, coordination between BSEC and Bangladesh Bank requires further strengthening as evidenced by limited consultations between the two regulators with respect to the Bangladesh Bank circular issuance on banks' equity risk exposure as a percentage of capital applicable on a consolidated basis that was issued on 25 February 2014.

16. By diversifying financial instruments and broadening the investor base, the CMDP 2 has helped to ensure balanced development of the financial sector. Diversification away from a predominantly bank-based system of financial intermediation expands alternative sources of financing, thereby helping to limit systemic impacts of economic shocks and mitigating the negative impact that financial market instability has on the plight of the poor. Capital markets stimulate healthy competition with the banking sector that results in lower financing costs for all borrowers. The CMDP 2, therefore, emphasizes specific capital market reforms to help Bangladesh diversify its financial system so that the country can realize its broad-based economic growth and socioeconomic development objectives—including poverty reduction.

V. Capital Market Indicators

17. The Government has very effectively kept to a schedule of challenging reforms. With the exception of one action, submission to Parliament of the Financial Reporting Bill, all actions to date have been fulfilled. As part of this strong Government commitment, reforms have been rolled out, and there is increasing confidence in the market as the new policies and regulatory incentives under the CMDP 2 gain traction. The market has stabilized, as evidenced by the 19% increase in market capitalization to $39.16 billion (as of 28 August 2014) from $33 billion in February 2011. The contribution of the banking sector has shown a healthy reduction of exposure to the stock market and has decreased to 14.8% at the end of FY2014's third quarter from 17.0% in the previous quarter (Figure 1).

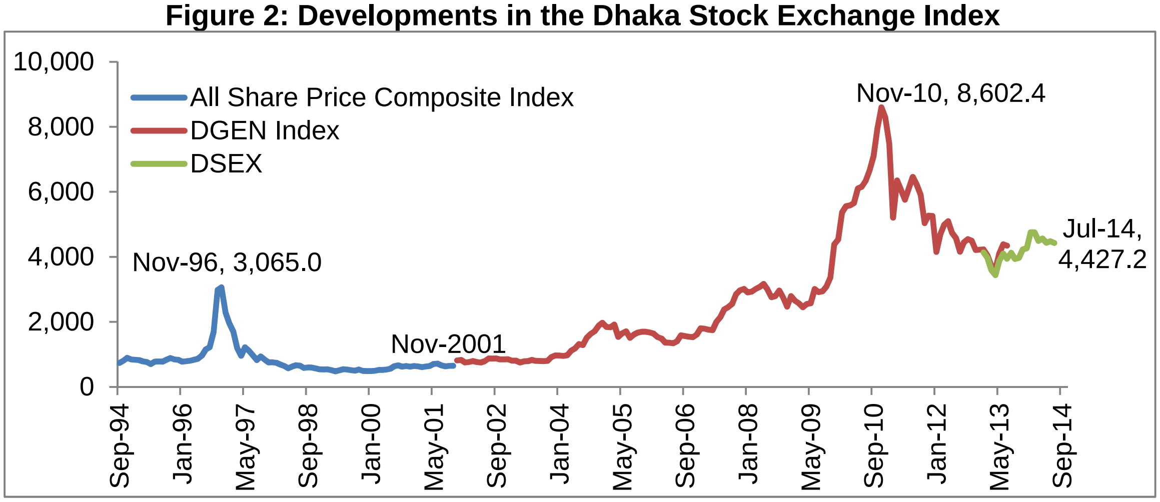
Figure 1: Dhaka Stock Exchange Market Capitalization



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

18. The rising trend of the Dhaka Stock Exchange (DSE) index and market capitalization continued during FY2014. At the end of FY2014, the DSE Broad Index (DSEX) stood at 4480.52, up 9.2% from the previous year's 4104.65. This trend continued as DSEX increased to 4427.16 in July 2014, a 12.3% increase from the previous year's 3940.81 (Figure 2).

Figure 2: Developments in the Dhaka Stock Exchange Index



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

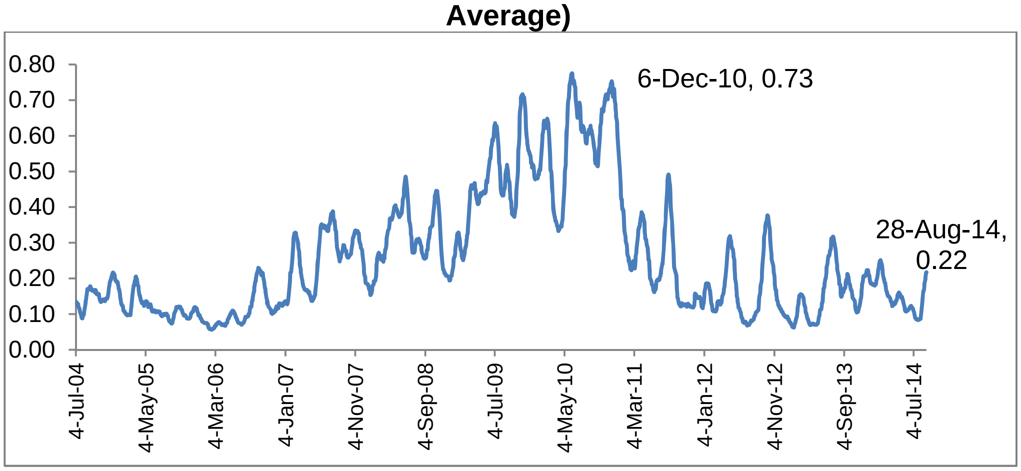
19. With regard to valuation, the DSE average price–earning (P/E) ratio was at 16.00 in May 2014. That is certainly more attractive from an investor's perspective than the average P/E ratio of 30.6 at its recent peak in February 2010 highlighting growth potential for investors over the medium term (Figure 3).

Figure 3: Average Price–Earnings Ratios at the Dhaka Stock Exchange

Source: Dhaka Stock Exchange (DSE).

20. The turnover ratios in 2014 are comparable with the levels recorded during 2004–2006, at which time the market had been functioning in a stable environment. The DSE average daily turnover as a percentage of market capitalization during January 2014 to August 2014 was 0.15% as compared to a high of 0.73% on 6 December 2010 (Figure 4).

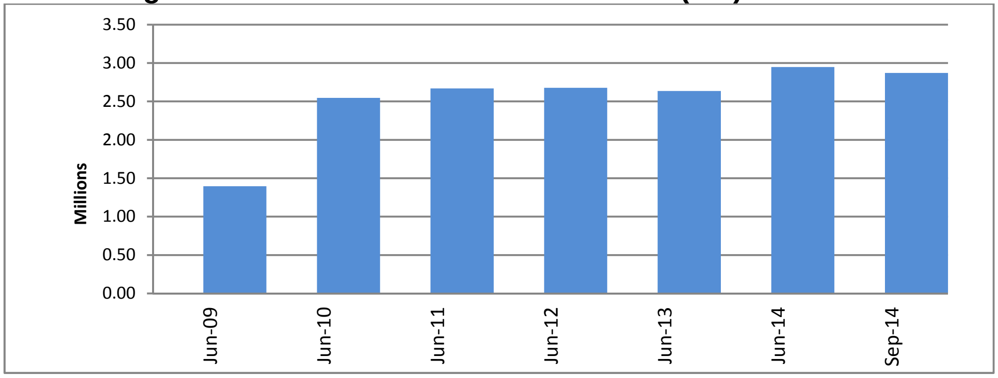
Figure 4: Dhaka Stock Exchange Turnover as % of Market Capitalization (20-Days Moving Average)



Source: Dhaka Stock Exchange (DSE).

21. Following a period of stagnation, recent growth in the number of active Beneficial Owner (BO) accounts suggests that retail investors are returning to the capital markets based on investor growth prospects over the medium term (Figure 5).

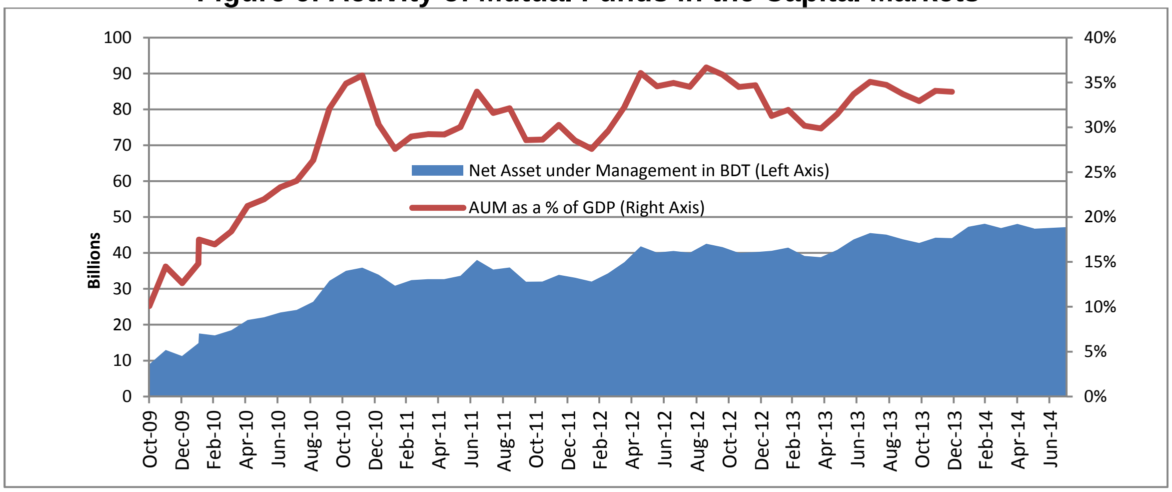
Figure 5: Active Retail Beneficial Owner (BO) Accounts



Source: Dhaka Stock Exchange (DSE).

22. The capital markets are building confidence as evidenced by higher activity in the mutual fund industry. Retail investors are returning to the capital markets through collective investment vehicles (Figure 6).

Figure 6: Activity of Mutual Funds in the Capital Markets



Source: Dhaka Stock Exchange (DSE).

23. A total of 9 companies have floated initial public offerings thus far in 2014. There were 17 such offerings in 2013 and 14 in 2012. As a result, the number of listed titles at the DSE increased to 538 in May 2014 from 529 as of December 2013 and 515 as of December 2012. Net foreign portfolio investment has gained consistently since early 2012, thus indicating the market's recovery and the attractiveness of the prevailing stock price valuations. During the third quarter of FY2014, new investment in shares by foreign and nonresident Bangladeshi investors increased to Tk9.4 billion from Tk4.41 billion in the same quarter of FY2013. At the same time, total share sales by foreign and nonresident Bangladeshi investors also increased to Tk5.4 billion during the third quarter of FY2014 from Tk1.47 billion in the same quarter one year earlier. As a result, net investment of foreign and nonresident Bangladeshi during the third quarter of FY2014 increased to Tk4.0 billion from Tk2.94 billion in FY2013's third quarter.

VI. Linkage to CMDP 3

24. Developing stable, resilient financial markets is not a goal on its own but rather a process that can support development and growth in an economy. Bangladesh has made very

significant strides towards strengthening capital markets as set out in its capital market master plan. Critical legislation has been passed under CMDP 2 including amendments to the SEC Act, Securities and Exchange Ordinance, Bank Companies Act, Income Tax Ordinance, and Stamp Act, as well as enactment of the Demutualization Act, and the pending Financial Reporting Act that has set the foundations for market development. A follow-up operation is proposed under the Third Capital Market Development Program (planned for the first quarter of 2015) to enhance the sustainability of structural reforms under CMDP 2. The proposed CMDP 3 will deepen and broaden the outreach of the CMDP 2 reforms by (i) extending the government yield curve and therefore promoting more liquid government and eventually corporate bond market; (ii) catalyzing institutional investor demand, by broadening, deepening and diversifying the investor base such as by enhancing pension and provident fund participation, (iii) strengthening the insurance sector to enhance coverage and outreach through recapitalization of insurance companies that is sequenced with actions to ensure active investment and participation in the capital markets; (iv) promoting Islamic bond market development through creation of an enabling environment to encourage *sukuk* issuance; and (v) promoting key building blocks including hedging instruments for market participants to diversify risks including through the development of simple derivatives such as interest rate derivatives and foreign exchange derivatives.

25. The CMDP 3 preparatory work is progressing well and an inception report has been submitted to the Government. In addition, two workshops were organized bringing in 50 participants covering Government officials, regulators and market participants to build a policy dialogue to forge a consensus on a set of actions to sustain the reform process. Efforts to strengthen the primary dealer system have also been pursued including arranging a study tour to exposed key officials to international best practices. The Aries Group Limited was engaged under the CMDP 3 project preparatory technical assistance (PPTA) to ensure continuity of services and prompt provision of consultancy services that would safeguard uninterrupted flow of the critical capital market reform process. The CMDP 3 PPTA represents a natural continuation of previous work carried out by the Aries Group (i.e. formulating the CMDP 2). Continuity in the technical approach and experience acquired in the process is imperative to foster strong linkage and smooth transition in the development of the sequence-oriented capital market reform process. The TA consultants have built strong relationships with all the key stakeholders and market participants since their previous stint in formulating the CMDP 2. The current consulting team in partnership with their domestic counterpart, Asian Tiger Capital, includes a Capital Market Development Expert, Capital Market Legal and Regulatory Experts, Capital Market Products Risk Management Experts, Capital Market Institutional Experts, and Insurance Experts that have been working closely with the relevant Government agencies such as IDRA, National Board of Revenue, BSEC, Bangladesh Bank, and Ministry of Finance and ADB staff to effectively diagnose the issues that would lead to a strong and relevant proposed policy matrix. The confidence placed by all the stakeholders in the firm builds a strong platform to catalyze and accelerate the further structuring of the capital market development agenda.

VII. Next Steps

26. Under the CMDP 3 PPTA, the consultants will submit the interim report, draft final report, and final report to the Government during the fourth quarter of 2014. An ADB Fact-Finding Mission will also be fielded during the fourth quarter of 2014 to discuss and finalize the contours of the CMDP 3 design with the Government. Loan negotiations between the Government and ADB are scheduled to be held in Dhaka during the first quarter of 2015. The negotiations would be followed by ADB Board consideration of the CMDP 3 by the end of the first quarter of 2015 at the latest.