SECTOR ASSESSMENT (SUMMARY): FINANCE (CAPITAL MARKETS)

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **Market stabilization.** Capital markets in Bangladesh show evidence of greater stability and resilience. Following the stock market debacle in December 2010, reforms were rolled out through a strong partnership between the government and the Asian Development Bank (ADB). The market has gradually rebuilt confidence, reflecting increasing traction from policies and regulatory reforms under the recently concluded Second Capital Market Development Program.[1] (CMDP 2). CMDP 2 was based on a two-track approach that sought to put firewalls in place to support market stabilization while planting the seeds for key reforms—leading to balanced, resilient, and sustainable market development. The stock market has stabilized, as evidenced by the 31% increase in market capitalization from February 2011 to September 2015. The contribution of the banking sector has shown a significant reduction of exposure to the stock market, and declined to 14.4% at the end of August 2015 from 28.8% in December 2010. The turnover ratios in January 2014–September 2015 are comparable with levels recorded during January 2004–December 2006, when the market was functioning in a stable environment. The Dhaka Stock Exchange (DSE) average daily turnover as a percentage of market capitalization during January 2014–September 2015 was 0.15% compared with a high of 0.73% on 6 December 2010.

2. **Limited role of capital market in resource mobilization.** Despite Bangladesh's major strides toward strengthening its capital markets, these markets need to be more effective in channeling savings to support investment and growth. Domestic capital markets do not yet play a significant role in financial intermediation and resource mobilization compared with the banking sector. New capital raised from the private sector through equity and bond issues combined was only 0.2% of gross domestic product (GDP) in FY2014 whereas industrial term loans by banks and financial institutions amounted to 3.1% of GDP in FY2014. This imbalance exposes the bank-dominated financial system to systemic vulnerabilities such as maturity mismatch issues.

3. **Structural weaknesses in capital market restraining much-needed investment.** Vision 2021 sets a target of reaching 10% GDP annual growth by FY2021, which requires an increase in the investment rate from 28.7% of GDP in FY2014[2] to 38%–40% of GDP by FY2021.[3] The Sixth Five-Year Plan targets an increase in investment in infrastructure from 2% of GDP to 6% of GDP.[4] Bangladesh is still unable to tap its capital markets efficiently for long-term infrastructure investment requirements despite having a national savings rate of 30.5% of GDP in FY2014. The absence of an active bond market significantly contributes to the lack of infrastructure financing from domestic funds and reflects structural impediments in the capital market. The equity-dominated capital market is characterized by a lack of transparency, poor accounting and auditing standards, and retail investors who lack sophistication and tend to react to rumors rather than being guided by underlining economic and financial fundamentals.

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1 ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the People's Republic of Bangladesh for the Second Capital Market Development Program*. Manila.
2 The investment rate of GDP increased from 24.4% in FY2009 to 28.7% in FY2014.
3 Government of Bangladesh, Planning Commission, Ministry of Planning. 2010. *Outline Perspective Plan of Bangladesh, 2010–2021: Making Vision 2021 a Reality*. Dhaka.
4 Government of Bangladesh, Planning Commission, Ministry of Planning of Bangladesh. 2011. *Sixth Five-Year Plan, FY2011–FY2015*. Dhaka.

4. **Strained supervisory capacity of the Bangladesh Securities and Exchange Commission.** Although oversight and regulatory functions have more than doubled at the Bangladesh Securities and Exchange Commission (BSEC), staffing remains inadequate, which constrains BSEC from carrying out its mandate effectively. Furthermore, the absence of an information and communication technology (ICT) system at BSEC limits the effectiveness of the regulator. The approval of BSEC's organogram will significantly enhance its regulatory and enforcement capacity as well as promote market stability through the induction of an additional 456 full-time staff (current staff size is 164). The installation of an ICT system at BSEC will create synergistic effects at the regulatory agency by raising the productivity levels of the expected staff size of 620. The enhanced enforcement capacity will be complemented by expedited adjudication of enforcement actions through the operationalization of a special tribunal for capital market-related cases.

5. **Weak intermediary industry.** The intermediary industry comprises 230 broker dealers and merchant banks. Overall, the industry is in a weakened financial condition as a result of margin lending related losses during the stock market debacle in December 2010. The issuance of risk-based capital rules for intermediaries and the subsequent implementation of a recapitalization plan are essential to consolidate the number of intermediaries in the industry as well as ensure that the remaining intermediaries are adequately capitalized and financially sound.

6. **Demutualization of stock exchanges.** DSE and Chittagong Stock Exchange were demutualized to become commercial and more professionally run organizations under CMDP 2. 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 successful inclusion of strategic investors will facilitate the development of crucial new technology infrastructure. Market efficiency will subsequently be enhanced, which will enable the introduction of exchange-traded products such as exchange traded funds and exchange traded derivatives.

7. **Limited reliability of financial reporting**. Lack of transparency in the financial reporting of listed companies is one of the major factors limiting investors' participation in capital markets. With the passage of the Financial Reporting Act (FRA) in 2015, an independent Financial Reporting Council will be established to adopt the International Accounting Standards and International Standards of Auditing. These upgraded accounting and auditing standards will enhance investor confidence and allow for informed investment decisions.

8. **Constraints on equity financing.** During the post-correction period, the number of initial public offerings (IPOs) increased during from four (total value: Tk860 million) in 2010 to 17 (total value: Tk9,894 million) in 2014 as more companies sought equity financing. Amendment of the IPO book building rules to make the price discovery method more effective will further incentivize equity financing. A reduction in the IPO lock-in period for licensed private equity investors will also spur private equity fund activity in the capital markets. Amendment of the Takeover and Control Rule, 2012 will restore potential bidders' confidence in mergers and acquisitions as a tool of business expansion.

9. **Underdeveloped bond market.** The bond market lacks depth and liquidity. It accounts for only 12% of GDP and lags behind the bond markets of other Asian countries (Table). The market is dominated by government bonds, with an almost nonexistent corporate bond market.[5] Development of the bond market is hindered by the government's issuance practices, which

[5] Some 221 government bonds and three corporate bonds were listed in the DSE as of December 2014.

have prevented the establishment of credible yield curves. National Saving Certificates, issued mainly in 3–5 year terms and at attractive interest rates, crowd out government and corporate bond issuance.[6]

Table: Regional Comparisons of Government and Corporate Bond Markets, 2014

Country	**Total Bond Market** (% of GDP)	**Government Bond** (% of GDP)	**Corporate Bond** (% of GDP)
Bangladesh	12	11	<1
India	44	31	13
Pakistan	36	34	2
Sri Lanka	42	41	1

GDP = gross domestic product.
Sources: ADB. *Asian Bond Monitor, November 2014*. Manila; Reserve Bank of India; Securities and Exchange Board of India; Ministry of Statistics and Programme Implementation of India; Bangladesh Bank.

10. **Limited tradable bonds caused by barriers facing primary dealers.** Only a small amount of government bonds is available for trading, as (i) most are held to maturity by banks (12 of them are also primary dealers) for statutory liquidity requirements,[7] and (ii) the government allocation system, including a practice of devolvement, obliges primary dealers to buy the unsold government bonds often at below market rates,[8] which cannot be sold at secondary bond market. A strategy of creating liquid benchmark issues should be further promoted through the introduction of floating rate notes in the government bond auction system and allowing for short selling of government securities, which would allow positions to be hedged—generating secondary bond market activity.

11. **Supply and demand constraints of corporate bonds.** The absence of an active secondary market to provide credible yield curves for the pricing of corporate bonds is a major factor constraining corporate bond supply and demand. Corporate bond issuances are hindered by regulatory provisions such as (i) a 60:40 debt equity ratio ceiling requirement, (ii) shareholder approval requirement, and (iii) submission of a fixed-term sheet by the issuer.

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

13. **Limited capital market investment by insurance companies**. The insurance industry is growing but remains small, with total assets amounting to 2.5% of GDP in FY2014. Its participation in the debt capital market is insignificant. Life insurance companies have invested heavily in real estate. To safeguard policyholders from potential losses resulting from such risky investment strategies, the Insurance Act, 2010 includes asset investment and recapitalization measures that are yet to be adopted. The capacity of the regulator, the Insurance Development and Regulatory Authority, is constrained by inadequate staffing.

14. **Mutual funds at early stage of development.** The mutual fund sector is small, with less than 1% of total market capitalization in DSE in 2014, and lags behind its neighboring countries.[9] To promote mutual funds, a level playing field between Investment Corporation of

[6] National Saving Certificates account for 35.6% of the outstanding stock of government debt as of September 2014.
[7] Conventional commercial banks are effectively required to have 13% of total deposits in government securities.
[8] In FY2014, 21% of the accepted bids for treasury bonds with tenors of 2 years or longer were devolved.
[9] The net asset value of mutual funds to total market capitalization is about 10% in India.

Bangladesh and non-Investment Corporation of Bangladesh funds is crucial, the same tax treatment between fixed-income mutual funds and equity mutual funds is required, and types of mutual funds need to be increased (such as the introduction of exchange traded funds).

15. **Limited supply of alternative financial instruments.** Development of a deeper and broader capital market entails the promotion of alternative financial instruments. Bangladesh also has socioeconomic needs for Islamic capital market instruments. The Islamic banking industry controls more than 20% of total banking assets in Bangladesh, but only two private sector Islamic bonds have been issued. *Sukuks* (Sharia compliant bonds) should be promoted as long-term financing tools for infrastructure projects. Lack of a regulatory framework is a major factor for the absence of *sukuk*s.

16. **Lack of derivatives market.** Derivatives provide firms with tools to manage exposure to various risks effectively. Although derivatives, such as interest rate swap or currency swaps, are not actively traded, there is a high level of interest in developing the derivatives market by the regulator, domestic and international market participants. An efficient derivatives market requires a deep and liquid spot market for their underlying assets from which to draw pricing information. As a spot market develops, derivatives should be introduced under an enabling regulatory framework to deepen capital markets. The establishment of a clearing and settlement company will complement the derivative market by providing the requisite platform.

2. Government's Sector Strategy

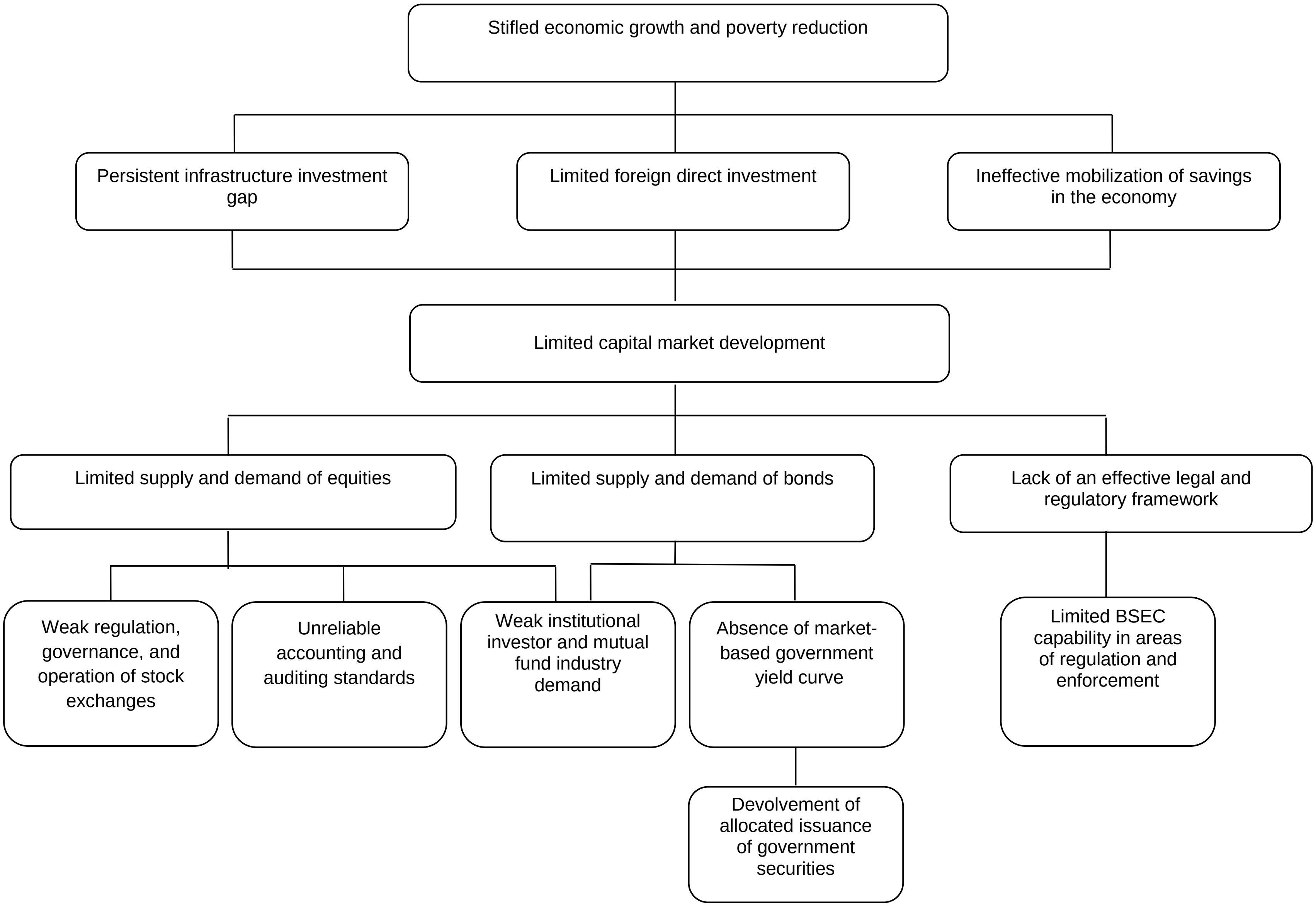
17. Vision 2021 lays out the perspective plan for Bangladesh to attain middle-income status by 2021. The Sixth Five-Year Plan focuses on removing growth constraints through massive investment in infrastructure, expecting the private sector to drive most of the growth. Policy actions will focus on providing incentives for private sector development by promoting long-term financing options through capital market development. The formation of a long-term national capital market plan and national insurance sector policy under CMDP 2 ensure that the Third Capital market Development Program is an integral part of a government-owned long-term development strategy.

3. ADB Sector Experience and Assistance Program

18. ADB's financial sector strategy for Bangladesh is included in the country partnership strategy[10] and country operations business plan.[11] The strategy is aligned with the Sixth Five-Year Plan, lessons from ADB's previous financial sector interventions, and coordination with other development partners. It is also consistent with ADB's Midterm Review of Strategy 2020,[12] where financial sector development focusing on the provision of long-term infrastructure is one of ADB's focus areas in its Bangladesh public sector operations. ADB provided the first capital market development program in 1997[13] and the second program in 2012 (footnote 1). The most important lesson learned from both programs was that for a policy-based program loan to be feasible, it has to be an integral part of a government-owned reform and long-term development strategy. Ownership at the highest levels of government in particular, and by all stakeholders, is of paramount importance. Furthermore, ADB needs to prioritize reform measures, set realistic time lines, and ensure strong implementation through interagency coordination headed by a champion of reform.

[10] ADB. 2011. *Country Partnership Strategy: Bangladesh, 2011–2015*. Manila.
[11] ADB. 2014. *Country Operations Business Plan: Bangladesh, 2015–2017*. Manila.
[12] ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila
[13] ADB. 1997. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the People's Republic of Bangladesh for the Capital Market Development Program*. Manila.

Problem Tree



Sector Results Framework

Country Sector Outcomes		Country Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contribution	**Indicators with Targets and Baselines**	**Outputs with ADB Contribution**	**Indicators with Incremental Targets**	**Planned and Ongoing ADB Interventions**	**Main Outputs Expected from ADB Interventions**
Enhanced size, depth, and capacity in capital market More efficient, transparent, and well-regulated capital market	Equity financing as the percentage of GDP increases to 0.2% by FY2018 (Baseline: 0.05% in FY2014) Stock market capitalization increases to 20.4% of GDP by December 2017 (baseline: 17.6% in FY2015) Enlistment of new securities increases to 570 by December 2017 (Baseline: 555 in FY2015) Total value of corporate bonds issued increases to Tk19 billion by December 2017 (Baseline: Tk15.6 billion in FY2014)	Better-governed and stable capital and bond markets Enhanced supply of and demand for equities and bonds Availability of stable sources of financing for small, medium, and large infrastructure projects	Reliable benchmarks established for government bond market Greater investor confidence with well-regulated and transparent capital market Infrastructure projects financed under public–private partnerships	**Planned target subsectors** Capital market development, supporting reforms for strengthening capital market policy, improving market governance, strengthening regulatory enforcement, and infrastructure financing through the bond market **Pipeline projects with estimated amounts** Disaster Risk Financing ($1.5 million) **Ongoing projects with approved amounts** None	**Planned target subsectors** A better governed, well-developed, transparent, and efficient capital market Government bond market developed and provided impetus for corporate bond development Availability of alternative source of financing for public–private partnership projects **Pipeline projects** Availability of alternative source of financing (catastrophe bonds) **Ongoing projects** None

ADB = Asian Development Bank, GDP = gross domestic product.
Source: Asian Development Bank.