CAPITAL MARKET DEVELOPMENT IN BANGLADESH

A SECTOR REFORM PERSPECTIVE

Syed Ali-Mumtaz H. Shah

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ABBREVIATIONS

ADB	–	Asian Development Bank
BSEC	–	Bangladesh Securities and Exchange Commission
CMDP	–	Capital Market Development Program
DSE	–	Dhaka Stock Exchange
GDP	–	gross domestic product
ICB	–	Investment Corporation of Bangladesh
ICT	–	information and communication technology
IDRA	–	Insurance Development and Regulatory Authority
IPO	–	initial public offering
MOF	–	Ministry of Finance

EXECUTIVE SUMMARY

This paper 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 toward strengthening its capital markets as set out in its capital market master plan. Through a strong partnership between the government and the Asian Development Bank, reforms have been rolled out, and the market is building confidence as policies and regulatory incentives under the Second Capital Market Development Program (CMDP 2) and the ongoing Third Capital Market Development Program (CMDP 3) gain traction.

The CMDP 2 addressed structural deficiencies in Bangladesh's capital markets by boosting economic growth and deregulating the financial system to better support the real economy by promoting private sector investment. The CMDP 2 was based on a two-track approach that sought to put firewalls in place to support market stabilization following 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. The ongoing CMDP 3 is enhancing sustainability of structural reforms under the CMDP 2 by deepening and broadening the outreach of the second program reforms by (i) extending the government yield curve and therefore promoting a more liquid government bond market and eventually corporate bond market; (ii) catalyzing institutional investor demand by broadening, deepening, and diversifying the investor base; and (iii) enhancing the supply of alternative financial instruments.

I. INTRODUCTION

Bangladesh has made very significant strides toward strengthening capital markets as set out in its capital market master plan (2012–2022). Through a strong partnership between the Government of Bangladesh and the Asian Development Bank (ADB), reforms have been rolled out, and the market is building confidence as the new policies and regulatory incentives under the Second Capital Market Development Program (CMDP 2) and ongoing Third Capital Market Development Program (CMDP 3) gain traction. The CMDP 2 addressed structural deficiencies in Bangladesh's capital markets by boosting economic growth and deregulating the financial system to better support the real economy by promoting private sector investment. The CMDP 2 was based on a two-track approach that sought to put firewalls in place to support market stabilization following 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. The ongoing CMDP 3 is enhancing sustainability of structural reforms under the CMDP 2 by deepening and broadening the outreach of the second program reforms by (i) extending the government yield curve and, therefore, promoting a more liquid government bond market and eventually corporate bond market; (ii) catalyzing institutional investor demand by broadening, deepening, and diversifying the investor base; and (iii) enhancing the supply of alternative financial instruments.

II. STOCK MARKET DEBACLE OF 2010

Bangladesh's stock markets were 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 grave concern that a perfect storm could result in a negative feedback loop from the financial sector to the real economy, potentially bringing the economy to a grinding halt.

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 probe also highlighted limited enforcement of regulation by the Bangladesh Securities and Exchange Commission (BSEC) and commercial banks' excessive investment in stock markets.

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.

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 fueling the stock market boom, which, following bull runs, proved unsustainable and led 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 BSEC, lax and excessive reliance on margin lending requirements, unreliable financial reporting standards, and weak coordination across financial regulators (ADB 2011a). Weak investor confidence prevailed in the capital markets and, therefore, limited demand for equities and bonds. Lax regulatory enforcement of 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.

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

III. GROWTH IMPERATIVE AND INFRASTRUCTURE CHALLENGE

From a structural perspective, a lack of sustainable long-term infrastructure financing options also persists in the economy because of limited capital market development. The government's Vision 2021 lays out a roadmap for Bangladesh to attain middle-income status by 2021.[1] It sets a target of reaching 10% GDP annual growth by FY2021. The Sixth Five-Year Plan, FY2011–FY2015 included a growth strategy to boost the rate of private investment and foster structural change (Government of Bangladesh 2011). If Bangladesh is to attain its GDP growth targets, it would have to address structural deficiencies in the capital markets—by deregulating the financial system to support the real economy and promote private sector investment to reduce the infrastructure deficit, which is a major constraint to its sustainable and higher economic growth.

IV. GOVERNMENT POLICY SUPPORT FOR CAPITAL MARKET DEVELOPMENT

To achieve the GDP growth rate targets outlined in Vision 2021, the government recognized the need to strengthen macroeconomic management, deepen enabling policy and regulatory reform, and improve the incentive structure for encouraging private investment. It would have to develop an enabling policy and institutional framework that targeted (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., BSEC) by reducing government tutelage were crucial to develop a more stable and resilient financial system. Policy reforms were therefore envisioned under the Sixth Five-Year Plan to improve incentives

[1] Government of Bangladesh. 2010.

for private investment. These incentives included providing long-term financing options through capital market development. The key envisaged capital market development reforms included (i) strengthened market surveillance by BSEC; (ii) improved regulations with respect to accounting rules, governance structure, and reporting requirements; (iii) strengthened market surveillance by BSEC; (iv) improved regulations with respect to accounting rules, transparency issues, governance structure, and reporting requirements; (v) enhanced criteria for determining insider trading; (vi) sanctions (criminal and financial) for violations of the rules and regulations; (vii) increased equity issuance through strengthening of the initial public offering (IPO) book-building method; and (viii) greater coordination between Bangladesh Bank and BSEC on stock market policies, including issues related to commercial banks' exposure to the capital market.

V. ADB SUPPORT FOR CAPITAL MARKET DEVELOPMENT

Since the late 1980s, the government and ADB have conducted extensive policy dialogues on capital market development.[2] The dialogue provided the basis for project support that improved good governance practices in the capital market and the insurance sector, which led to the establishment of a new insurance regulatory authority in 2010 (ADB 2006). The Improvement of Capital Market and Insurance Governance Project (ADB 2006) also contributed to the CMDP 2 formulation, which was built from other key inputs, such as project preparatory technical assistance in 2011 (ADB 2011b), a study of the role of banks in Bangladesh's stock market volatility in June 2011 (ADB 2011a), and a study on demutualization of stock exchanges in Bangladesh in 2012 (ADB 2012c). The CMDP 3 includes reforms that are part of the national capital market master plan approved by the government under the CMDP 2 (BSEC 2012), and is built from diverse inputs that include its project preparatory technical assistance in 2014 (ADB 2013), the CMDP 2 attached technical assistance in 2013–2014 (ADB 2012a), and a study to develop Bangladesh's primary dealer system in 2013–2014 (ADB 2014). Comprehensive stakeholder consultations were held through numerous national workshops to analyze the issues effectively.[3] A major outcome of ADB's deep involvement in Bangladesh's capital markets is the promotion of BSEC to category A membership of the International Organization of Securities Commissions in December 2013.

ADB's intensive engagement with the government over the past 25 years has ensured that it is the lead development partner for capital market development in Bangladesh. ADB's strength lies in its integrated policy support which focuses on "how to do it" and covers (i) policy dialogue, (ii) structure and design of tailor-made policy reforms, (iii) policy implementation support, (iv) capacity development through technical assistance to ensure sustainability, and (v) procurement of information technology systems to strengthen operations. Few development partners have the same level of credibility, the means or the capacity to offer this solutions-based approach which can effectively and consistently tailor these best practices to the needs and conditions of Bangladesh's capital markets. In the absence of ADB involvement in capital market reforms, and, given the complexities, resources, and expertise, such reforms would not have happened, may have happened on a piecemeal basis undermining the synergies built under an integrated and holistic approach, or may have eventually been achieved some time in the future.

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[2] Since 1993, ADB has approved three major programs that include the Capital Market Development Program in 1997 as well as 18 technical assistance projects in capital market development, which have built the reform momentum leading to the proposed program. Through these programs, ADB has uniquely gained an in-depth understanding of Bangladesh's capital markets for effectively managing reforms.

[3] Eight national stakeholder and dissemination workshops were held for demutualizing the stock exchanges, developing the primary dealer system, and formulating the second program and the third program.

A. Second Capital Market Development Program Design

The CMDP 2 supported the government's reforms and comprised (i) a program loan to support vital capital market reforms, and (ii) an associated technical assistance grant to facilitate implementation of key reform actions under the program (ADB 2012b). The objective of the CMDP 2 was to stabilize the financial markets and facilitate sustainable growth by (i) strengthening market stability by enhancing the role of 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.

B. Second Capital Market Development Program Results

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 brought about reforms that set the foundation for sustainable market development through the passage of critical legislation, which included amendments to the Securities and Exchange Commission Act, 1993; the Securities and Exchange Ordinance, 1969; the Bank Companies Act, 2013; the Income Tax Ordinance, 1984; and the Stamp Act, 1899; as well as the enactment of the Demutualization Act, 2013 and the Financial Reporting Act, 2015.

The CMDP 2 was based on a two-track approach that sought to put firewalls in place to support market stabilization following 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, BSEC was to be given a stronger mandate, together with resources recognizing that operational autonomy required financial autonomy. The operational and financial efficiency of BSEC was enhanced by (i) allowing unhindered access to the BSEC fund, (ii) removing government approval of BSEC budget or expenditures from the BSEC fund, and (iii) providing benefits to BSEC staff comparable to those at Bangladesh Bank generally considered improved conditions relative to government civil servants. That allowed BSEC to strengthen its cadres and 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 (Carrasco and Shah 2013).

The introduction of a real-time state-of-the-art market surveillance system at 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, which include 15 cases brought as a result of the stock market crisis of 1996, are pending in various courts. 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 Financial Reporting Act in 2015 will play an integral role in upgrading the accounting and auditing standards to enhance market confidence. The enactment will be followed by the establishment of an independent financial reporting council under the ongoing CMDP 3 that would adopt International

Accounting Standards and International Standards on Auditing for the concerned entities, as well as to monitor and enforce them, and possess the authority to license auditors and accountants. The effective implementation of structural reforms to enhance BSEC's mandate was realized by the strong collaboration between BSEC and the Ministry of Finance (MOF) as well as their focused determination to provide a win–win situation to strengthen the financial system and better support the real economy.

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. The 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 the enactment of the Demutualization Act in April 2013, followed by the submission of the demutualization schemes by both stock exchanges (i.e., operational plans), and the approval of these schemes by BSEC in September 2013. The dedicated efforts of BSEC and the stock exchanges ensured successful implementation of these demutualization reforms.

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 the reform of the primary dealer system by fostering a more efficient price discovery mechanism in auctioning government securities. This entailed the government being a price-taker instead of a price-maker 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 (ADB 2014). The realization of primary pricing that reflects market fundamentals is imperative to ensure development of a secondary government bond market and therefore secondary market trading. 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 reopening 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 among BSEC, the MOF, and Bangladesh Bank.

The CMDP 2 also significantly reduced tax distortions in the capital markets through implementation of 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 IPO 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 (ICB) funds and the rest of the mutual fund industry. The majority government-owned ICB is a quasi-monopoly that seeks to ensure its own dominant position in the mutual fund market at the cost of deterring other mutual funds from tapping the market more effectively. The implementation of such groundbreaking tax policy reforms was made possible by the perseverance of the MOF and the National Board of Revenue.

On the institutional investor side, the CMDP 2 focused on enhancing insurance industry participation in the capital market to expand demand. Measures were introduced 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) 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 the appointment of the chief executive officer and management of the IDRA fund are being implemented since January 2013. From January 2013 to June 2014, chief executive officers were appointed across numerous insurance companies according to these guidelines. The salaries and benefits of the IDRA staff are paid by the IDRA fund in accordance with the IDRA fund guidelines. The effective coordination and cooperation between the MOF and IDRA ensured these integral reforms to promote the insurance industry were carried out.

Under the CMDP 2, financial stability was enhanced through improved coordination among regulators by making the council of financial regulatory agencies an effective body for financial sector oversight. The council, which includes all the agencies with a mandate for financial stability and financial sector oversight—Bangladesh Bank, BSEC, IDRA, and the MOF—adopted a specific mandate to include (i) macroprudential 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. The coordination between BSEC and Bangladesh Bank is still a work in progress that requires further strengthening.

C. Third Capital Market Development Program Design

The ongoing CMDP 3 is supporting the government's reforms and comprises (i) a program loan to support vital capital market reforms, and (ii) an associated technical assistance grant to facilitate implementation of key reform actions under the program (ADB 2015b). The ongoing program builds on stabilization measures introduced by the CMDP 2 and implements the roadmap in the long-term national capital market master plan that was formulated as a policy action under the CMDP 2. Capital market reforms are part of a deep-rooted process which requires continuous changes as traction and market confidence builds up. The objective of the CMDP 3 is to deepen and broaden the outreach of CMDP 2 reforms by (i) extending the government yield curve and, therefore promoting a more liquid government bond market and eventually corporate bond market; (ii) catalyzing institutional investor demand by broadening, deepening, and diversifying the investor base; and (iii) enhancing the supply of alternative financial instruments. The CMDP 3 will (i) strengthen market stability by enhancing BSEC's role to develop and monitor the market, strengthening regulatory measures, and developing a clearing and settlement company; (ii) enhance market facilitation by supporting more efficient mobilization and allocation of resources in the economy by expediting adjudication of enforcement actions, upgrading accounting and auditing standards, and pursuing completion of the demutualization of the stock exchanges; (iii) enhance supply measures by increasing the supply of quality bonds and alternative financial instruments through capital markets; and (iv) enhance demand measures by developing liquid bond markets, enhancing institutional investor demand, and promoting mutual funds (Carrasco and Shah 2015).

D. Third Capital Market Development Program Results

The key results of the ongoing CMDP 3 will primarily be achieved by June 2017. These include approval of BSEC's organogram, which will significantly enhance its regulatory and enforcement capacity as well as promote market stability through the induction of additional full-time staff. The installation of an information and communication technology (ICT) system at BSEC will create synergistic effects at the regulatory agency by raising productivity levels. In line with international best practice, the amendment of the IPO book-building rules to make the price discovery method more effective will promote equity financing. The CMDP 3 will facilitate the establishment of a clearing and settlement company, which will eventually enable a central counterparty entity to be the guarantor for the settlement of derivative contracts.

Under the CMDP 3, the enhanced enforcement capacity at BSEC has already been complemented by expedited adjudication of enforcement actions through operationalization of a special tribunal for capital market-related cases in November 2015. The establishment of an adequately funded financial reporting council (i.e., an independent audit oversight authority) will lead to adoption of the International Accounting Standards and International Standards on Auditing, which will enhance market confidence and allow for informed investment decisions. The CMDP 3 will support the completion of the demutualization process which entails the entry of strategic investors into both stock exchanges in 2017 that would facilitate the development of crucial new technology infrastructure.

Numerous measures will be introduced under the CMDP 3 to catalyze the corporate bond market. One of these measures, the removal of the 60:40 debt-to-equity ratio ceiling, was already implemented in November 2015. A reduction in the IPO lock-in period for licensed private equity investors will spur private equity fund activity in the capital markets and increase demand for equities. Alternative financial instruments (derivatives and *sukuks*[4]) will be promoted under the CMDP 3 to develop a deeper and broader capital market by focusing on the enabling regulatory framework. The issuance of *sukuk* rules will promote Islamic finance and increase the number of *sukuk* issues. The

[4] *Sukuk* commonly refers to the Islamic equivalent of bonds. However, as opposed to conventional bonds, which merely confer ownership of a debt, *sukuk* grants the investor a share of an asset, along with the commensurate cash flows and risk. As such, *sukuk* securities adhere to Islamic laws sometimes referred to as Shari'ah principles, which prohibit the charging or payment of interest.
http://thatswhy.isdb.org/irj/go/km/docs/documents/IDBDevelopments/Internet/thatswhy/en/sukuk/what-is-sukuk.html

introduction of regulations for issuing derivatives will encourage the development of instruments such as interest rate swaps and currency swaps that will support more efficient and liquid capital markets.

A strategy of creating liquid benchmark issues will be pursued under the CMDP 3 through the introduction of floating rate notes in the government bond auction system on a pilot basis. The issuance of floating rate notes expands the investor base beyond that of traditional bond investors and diversifies the borrower's funding costs away from being uniquely based on fixed rate coupons. The floating rate notes have minimal exposure to interest rate risk irrespective of their final maturity and are therefore inherently more liquid than similar maturity bonds. Liquid benchmark issues will also be promoted through generating market-making activity in government securities by allowing short selling of primary dealer-owned government securities that permit positions to be hedged, thereby catalyzing secondary bond market activity. Insurance industry participation in the capital market will be enhanced by first introducing measures to promote the industry's growth and stability, such as compliance with the minimum capital requirements of the Insurance Act, 2010, and then encouraging investor demand through issuance of investment guidelines by IDRA. The approval of the IDRA organogram under the CMDP 3 will significantly enhance IDRA's regulatory capacity. A robust mutual fund industry is being promoted under the CMDP 3 by rule changes that (i) ensure a level playing field between ICB and non-ICB funds by removing the exemption that allows ICB and its asset management company to act as trustee of the new funds where ICB itself is the sponsor, (ii) allow investors in fixed-income mutual funds the same tax treatment as equity mutual funds, and (iii) promote exchange-traded funds.

VI. LESSONS LEARNED

Both programs build on lessons from the second program completion report (ADB 2015a),[5] the first program performance audit report (ADB 2005), and the review by ADB's Independent Evaluation Department of ADB assistance for domestic capital markets (ADB 2008). In line with key recommendations of all three evaluation studies, the efficiency and effectiveness of both programs are facilitated by (i) a limited number of policy actions to monitor program compliance effectively; (ii) formulation and implementation of the long-term national capital market master plan, which ensures that the programs are an integral part of a government-owned long-term development strategy; and (iii) comprehensive consultation with stakeholders through numerous national stakeholder and dissemination workshops to effectively diagnose the issues leading to strong and relevant policy matrices that prioritize reform measures and set realistic time lines.[6]

Both programs pursue a holistic approach to ensure inclusion of insurance and pension areas and their links to capital market development (World Bank Group, IEG 2016). This allows for broadening, deepening, and diversification of the investor base by catalyzing institutional investor demand from the insurance and pension sectors. In line with spurring institutional investor demand, it is imperative to work at institutional strengthening, market infrastructure development, and capacity development simultaneously to ensure a strong foundation for multifaceted capital market development.

The programs focus on institutional strengthening of BSEC and IDRA to enhance their financial and operational efficiency. The installation and operationalization of a real-time state-of-the-art market surveillance system at BSEC to mitigate market abuses as well as an ICT system at BSEC to enhance organizational productivity also represent key elements of both programs. The capacity development

[5] The program is rated *successful*.
[6] Footnote 3.

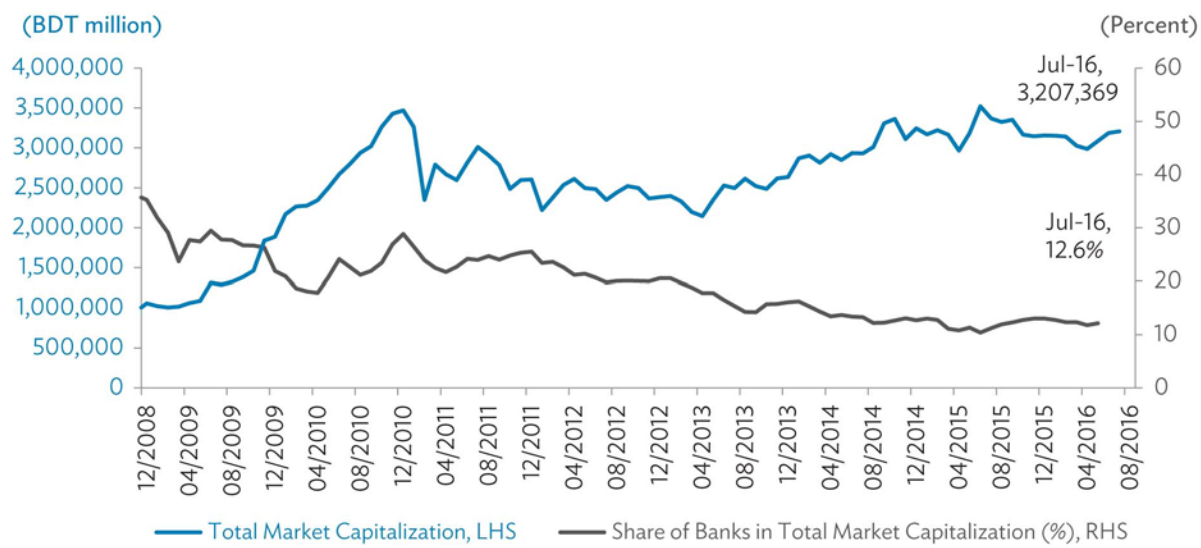
of key capital market players and/or institutions are crucial tenets of the programs such as enhanced capacity of the Dhaka Stock Exchange (DSE), Chittagong Stock Exchange, and BSEC to ensure effective implementation of the demutualization process. To build upon this foundation, measures that increase demand and supply of equities and bonds are crucial to generate a capital market reform growth scenario. Both programs include numerous measures to augment demand and supply of equities and bonds, such as removal of corporate bond transaction taxes and IPO taxes that facilitate capital market growth.

The attainment of the right balance between market development, financial system deregulation, and effective prudential oversight is crucial to ensure financial stability—a critical element for market confidence. The programs enhance market confidence through greater financial stability by maintaining a critical balance of reform measures divided between market development (such as demutualization of the stock exchanges), financial system deregulation (such as enhanced operational and financial efficiencies of BSEC and IDRA), and effective macroprudential oversight (such as institutionalization of coordination among regulators).

VII. CAPITAL MARKET INDICATORS

The government has effectively kept to a schedule of challenging reforms. 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 and the CMDP 3 gain traction. The market has stabilized, as evidenced by the 24% increase in market capitalization to about $41 billion (as of July 2016) 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 12.6% in July 2016 from 28.8% in December 2010 (Figure 1).

Figure 1: Dhaka Stock Exchange Market Capitalization



BDT = Bangladesh taka, LHS = left-hand side, RHS = right-hand side.
Source: Dhaka Stock Exchange.

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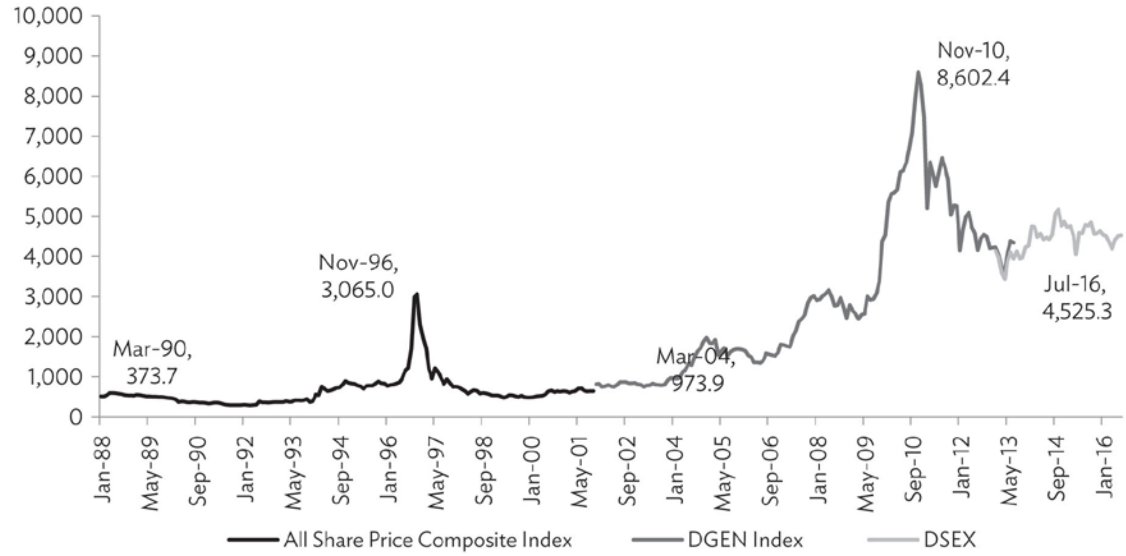
The rising trend of the DSE index and market capitalization continued during FY2015. At the end of FY2016, the DSE Broad Index stood at 4,507.6, up 1.0% from the previous year's 4,480.5 (Figure 2).

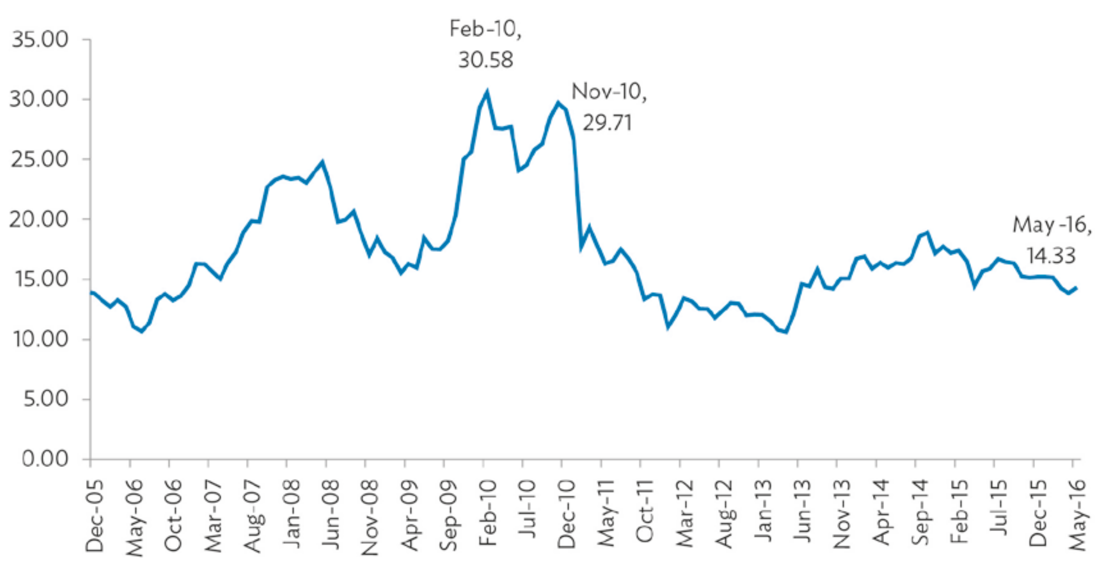
Figure 2: Developments in the Dhaka Stock Exchange Index



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

With regard to valuation, the DSE average price–earnings ratio was at 14.3 in May 2016. That is certainly more attractive from an investor's perspective than the average price–earnings ratio of 30.6 at its recent peak in February 2010, highlighting growth potential for investors over the medium term (Figure 3).

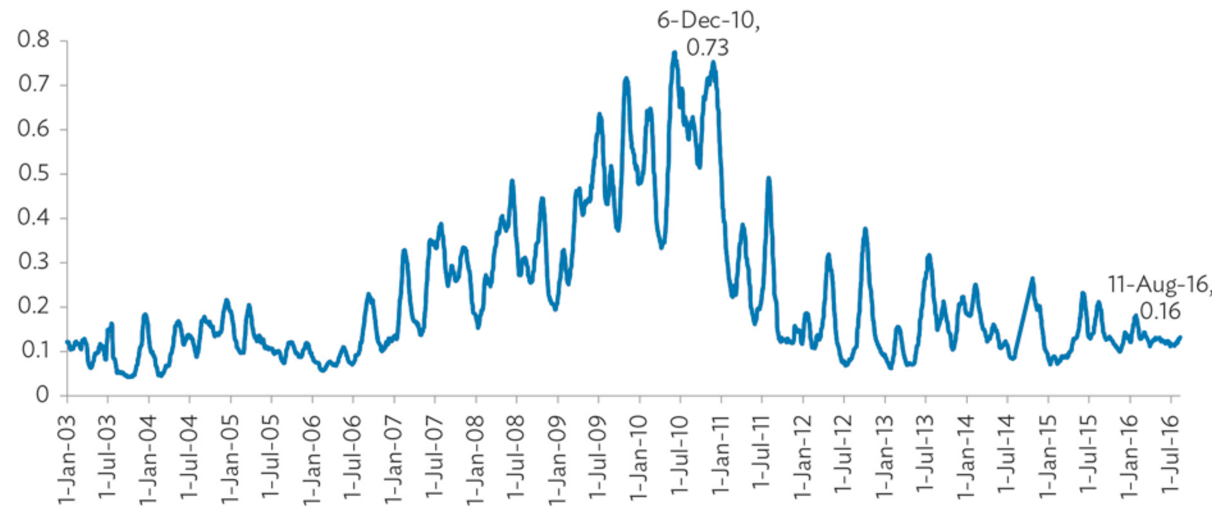
Figure 3: Average Price–Earnings Ratios at the Dhaka Stock Exchange



Source: Dhaka Stock Exchange.

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 on 11 August 2016 was 0.16% as compared to a high of 0.73% on 6 December 2010 (Figure 4).

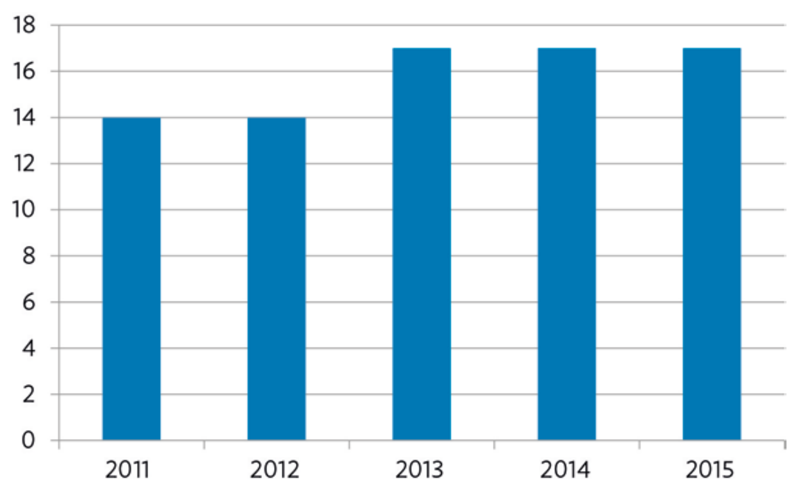
Figure 4: Dhaka Stock Exchange Turnover as Share of Market Capitalization
(%, 20-day moving average)



Source: Dhaka Stock Exchange.

A total of 17 companies floated IPOs in 2015. There were also 17 such offerings in 2014 and in 2013. As a result, the number of listed companies at the DSE increased to 559 in December 2015 from 542 as of December 2014 (Figure 5).

Figure 5: Number of Initial Public Offerings at the Dhaka Stock Exchange



Source: Dhaka Stock Exchange.

VIII. WHAT'S NEXT

Based on the government's capital market master plan (2012–2022), the key initiatives currently being pursued include consolidation of the intermediary industry, reform of the primary dealer system, establishment of a central clearance and settlement system, and recapitalization of insurance companies. The intermediary industry comprises 230 broker dealers and merchant banks. The issuance of risk-based capital rules for intermediaries in 2017 and the subsequent implementation of a recapitalization plan will consolidate the number of intermediaries in the industry as well as ensure that the remaining intermediaries are adequately capitalized and financially sound. To reform the primary dealer system, a strategy of creating liquid benchmark issues will be pursued through the introduction of floating rate notes in the government bond auction system on a pilot basis in 2017/18 and allowing for short selling of primary dealer-owned government securities in 2017/18 that permits positions to be hedged.

A legal framework to grant a license for establishing a clearing and settlement company will be approved by BSEC in 2017/18. The subsequent establishment of a clearing and settlement company will enable a central counterparty entity to be the guarantor for settlement of derivative contracts. The introduction of regulations in 2017/18 for issuing derivatives will encourage the development of instruments such as interest rate swaps and currency swaps. Insurance industry participation in the capital market will also be enhanced by first introducing measures in 2017/18 to promote the industry's growth and stability, such as compliance with the minimum capital requirements of the Insurance Act, 2010, and then encouraging investor demand through issuance of investment guidelines by IDRA in 2018.

IX. CONCLUSION

The CMDP 2 and the CMDP 3 appear to be a model intervention to strengthen capital markets. The CMDP 2 introduced stabilization reforms such as regulations on margin lending and equity exposure of banks as well as enhanced oversight and policy coordination. The CMDP 2 also brought about reforms that set the foundation for sustainable market development through the passage of seven critical pieces of legislation. The operationalization of BSEC's state-of-the-art market surveillance system under the CMDP 2 increased the transparency of market transactions and contributed significantly to enhanced investor confidence. The CMDP 3 builds on the stabilization measures introduced by the CMDP 2 and implements the roadmap in the long-term national capital market master plan. The CMDP 3 deepens and broadens the outreach of the CMDP 2 reforms by (i) extending the government yield curve and therefore promoting a more liquid government bond market and eventually corporate bond market; (ii) catalyzing institutional investor demand by broadening, deepening, and diversifying the investor base; and (iii) enhancing the supply of alternative financial instruments. The installation of BSEC's ICT system under the CMDP 3 will create synergistic effects at the regulatory agency by enhancing productivity levels.

The capital market reforms under the CMDP 2 and the CMDP 3 will facilitate the mobilization of financial resources for productive investment and employment generation by supporting the development of bond and equity capital markets. They will help ensure balanced development of the finance sector, which will reduce systemic vulnerabilities in the bank-dominated financial system. By addressing policy and regulatory constraints to the issues of corporate securities, both programs will help increase the number of bond and equity issues, both primary and secondary. This will facilitate the mobilization of scarce financial resources for long-term private sector investment, including infrastructure investment. By promoting the development of corporate securities markets and institutional investors, thereby diversifying financial instruments and broadening the investor base, both programs will also reduce market volatility and improve the resilience of the finance sector to external shocks. And lastly, by strengthening market governance in capital markets, both programs will enhance market efficiency and transparency, and improve investor protection (ADB 2012b).

The capital market reforms under both programs will play an important role in raising funds in a cost-effective manner and in enabling investors to gain access to alternative investment opportunities, as well as in mitigating the negative impact that financial market instability has on the plight of the poor. The diversification away from a predominantly bank-based system of financial intermediation expands alternative sources of credit, helping to limit the systemic impacts of economic shocks. Capital markets can stimulate healthy competition with the banking sector that results in lower financing costs for all borrowers. Both programs, therefore, emphasize specific capital market reforms to help Bangladesh diversify its financial system so that the country can realize its broad-based economic growth and socioeconomic development objectives, including poverty reduction.

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Capital Market Development in Bangladesh

A Sector Reform Perspective

Bangladesh has made very significant strides toward strengthening capital markets. This paper presents a summary of reforms in the capital markets undertaken by the Government of Bangladesh with a view to highlighting key results. The report outlines how—through a strong partnership between the government and the Asian Development Bank—reforms have been rolled out and the market is building confidence as policies and regulatory incentives under the Second Capital Market Development Program and the ongoing Third Capital Market Development Program gain traction.

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