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Annex II
INTERNATIONAL WORKSHOP ON DEVELOPMENT OF BOND MARKETS IN BANGLADESH[1] DECEMBER 1-2, 2004

I. Introduction

Accelerating economic growth and employment in the country requires acceleration of productive investment, which can be financed through borrowing from banks, issue of equity (or shares) and long-term bonds. For financing investment, historically in Bangladesh term loan from financial institutions far exceeded the level of outstanding value of publicly issued equity and debt. Even though banks in Bangladesh make some medium and long -term loans, they are unable to meet huge borrowing requirements of the economy. Bond market links issuers having long-term financing needs with investors willing to place funds in a long-term, interest bearing securities. A mature domestic bond market offers wide range of funding for the government and the private sector, with government bonds typically providing the foundation and creating opportunities for other issuers. While such fixed income instruments are the epitome of long-term finance options for government and corporate alike, the size of tradable government bond is small, secondary trading of government bonds is rare and more critically there has been no public issue of corporate bonds since 1996.

To promote development of bond market in Bangladesh an International Workshop on the Development of Bond Market in Bangladesh was organized by Bangladesh Bank (BB), in collaboration with the Securities and Exchange Commission (SEC), during December 1- 2, 2004 at the BRAC Centre in Rajendrapur. The objective was to bring together experts from the South and South-East Asia and the other regions to discuss and analyze policy and operational issues related to development of both government and corporate bond markets (including securitization and mortgage backed securities) in Bangladesh building on some recent progress in the area. In that context the experiences of other countries including that of the Asia Pacific region was also discussed. Dr. Fakhruddin Ahmed, Governor of Bangladesh Bank and Dr. Mirza Azizul Islam, Chairman of the Securities and Exchange Commission delivered the welcome address. The State Minister of Finance and Planning was the chief guest; Secretary, Ministry of Finance and senior officials of the World Bank, IMF were invited as special guests. Senior officials of Bank Negara, Malaysia, Reserve Bank of India, State Bank of Pakistan, Central Bank of Sri Lanka as well as private sector resource persons from the Asia Pacific region participated in the workshop as lead speakers or discussants. Noted central bankers from the region provided valuable insights about their experiences in the development of bond markets in Malaysia, India, Pakistan and Sri Lanka. Local participants included prominent bankers and delegates from financial institution and large corporations of the country.

II. Bond Market Development and the Role of the Regulators

Inaugural Session

Dr. Fakhruddin Ahmed, the Governor of Bangladesh Bank, noted in his opening address to the participants of the International Bond Conference, that the development of viable, liquid and deep government and corporate

[1] Prepared by Dr. Shahabuddin M, Hossain, Advisor to the Governor, Bangladesh Bank (one of the two Chief Coordinators of the Workshop) and Ms. Sabah Azim, Senior Executive, Investment Promotion and Development Corporation (IPDC) and a Rapporteur of the Workshop. They are particularly grateful to the then Governor of Bangladesh Bank Dr. Fakhruddin Ahmed for providing helpful suggestions and comments.

bond markets is essential for several reasons. Firstly, the issuance of government bonds will not only help finance deficits but also provide benchmark yield curve as reference on returns for other securities. Secondly, a deep and liquid bond market can help raise funds for the corporate sector. Thirdly, a deep and liquid bond market can address the asset-liability maturity mismatch facing banks and financial institutions in Bangladesh. Moreover, it can facilitate the diversification of financial assets and risks overwhelmingly concentrated on bank credit. Finally, well functioning government bond markets can strengthen the transmission and implementation of monetary policy instruments and enhance overall financial stability and competition. Dr. Ahmed informed the audience that in recent past the central bank has taken a number of initiatives to promote bond market development notably changes in legal and regulatory framework, as well as tax regime for securitization and issue of zero coupon bonds.

In his welcome speech Dr. Mirza Azizul Islam, Chairman of SEC noted that development of bond market require improvement of existing legal and regulatory frameworks, developing the market infrastructure and developing capacities of issuers, underwriters, trustees, traders and other market players; strengthen corporate governance, improving disclosure and transparency in business transactions to create confidence for investors and issuers alike. In this regard, the SEC has also taken steps to enhance disclosure requirement to improve investors' confidence and taking steps to improved market infrastructure and reduce transactions costs of new issue.

In his speech the State Minister of Finance representing the Minister of Finance (chief guest) welcomed the initiative to organize the workshop and outlined the steps taken by the government to develop government bond market and create an enabling economic environment. Zakir Ahmed Khan, Secretary, Ministry of Finance in his speech assured the support of the government in future initiatives to develop bond market. The heads of Bangladesh mission of the IMF and the World Bank in their speech underscored the critical importance of the bond market for overall development of financial market in the country. They lauded the timely initiative to hold the international workshop and reiterated their willingness to provide technical assistance for local capacity building for financial market development, as they did in the past.

Focus and Coverage of the Workshop

To address the major issues outlined above, the conference was organised in five sessions with two parallel presentations in each session spanning over two days shown below:

As shown below the workshop covered almost full range of issues and topics related to bond market development, starting with two opening sessions on government bond market, yield curve development and issues related to market infrastructure and secondary market development. Next, two parallel sessions are devoted to Corporate Bond market with lead speakers highlighting Bangladesh specific issues as well as transparency and corporate governance issues, critical to build investor confidence. Securitization, both technical issues and opportunities available in Bangladesh will be discussed fully in the third session based on recent development and momentum created by putting in place a legal and regulatory framework. In the same vein, two parallel sessions are also devoted to housing finance, covering both appropriate framework for public-private partnership and mortgage-backed securitization to leverage funds. Finally Session V is devoted to summing up and drawing lessons from the South Asian Experience and addressing the critical market impediments.

International Workshop on the Development of Bond Market in Bangladesh *Hosted by Bangladesh Bank and the Securities and Exchange Commission* *December 1-2, 2004; BRAC Centre, Rajendrapur, Dhaka.*		
Welcome Remarks: Governor, Bangladesh Bank & Chairman, SEC **Address by Chief Guest:** Honourable Minister for Finance and Planning (Represented by the State Minister) **Special Guests:** Ms. Christine Wallich, World Bank Country Director Mr. Nissanke Weerasinghe, IMF Mission Chief for Bangladesh		
Day	**Session**	**Topic**
1	Session 1A	**Developing the Yield Curve: Best Practices in Issuance and Management** Chair: Zakir Ahmed Khan, Secretary, Ministry of Finance Lead Speakers: Dr. A. G. Karunasena, Assistant. Governor, Central Bank of Sri Lanka Mr. Zafar M. Shaikh, Head of Treasury & Debt Management, State Bank of Pakistan
	Session 1B	**Bond Market Infrastructure and Secondary Market Development** Chair: Dr. Fakhruddin Ahmed, Governor, Bangladesh Bank Lead Speakers: Dr. R. H. Patil, Chairman, Clearing Corporation of India Mr. Ibrahim, Director: Investment Operations, Bank Negara, Malaysia Mr. Mangala Boyagoda (Consultant, SEC).
	Session 2A	**Development of Corporate Debt Instruments** Chair: Mr. Syed Manzur Elahi, Chairman APEX Group Lead Speakers:Mr. Ziaul H. Khandker, MD, Investment Corporation of Bangladesh (ICB) Mr. Yawar Sayeed, CEO, AIMS Bangladesh
	Session 2B	**Building Investor Confidence** Chair: Dr. Mirza Azizul Islam, Chairman, the SEC, Bangladesh Lead Speaker: Mr. R. Ravimohan, MD & CEO, CRISIL Ltd, India
		Combined Roundtable on Key Issues - Q& A Session Chair: Mr. Nissanke Weerasinghe, IMF Mission Chief for Bangladesh Panellists: Ms. Usha Thorat (RBI); Mr. Patil (Clearing Corporation of India); Prof. Abu Ahmed, Chairman, Shilpa Bank; Mr. Ravimohan (CRISIL, India); Dr. S. M. Hossain, Advisor to the Governor, Bangladesh Bank; Mr. Z. H. Siddiqui, ED, Bangladesh Bank, Mr. Md. Ali, Member, SEC; Mr. M. Alam, E.D. SEC; Mr.Z. H. Khandker, MD, ICB;
2	Session 3A	**Scope and Opportunities of Securitization** Chair: Mr. Aminur Rahman, Secretary, Ministry of Commerce Lead speakers: Mr. Majaedur Rahman, DMD, IPDC Mr. Prashant Purker (ICICI, India);
	Session 3B	**Structuring and Collateral Issues in Securitization** Chair: Ms. Christine Wallich, World Bank Country Director Lead speakers: Mr. Bruce Arnold, Australia (FIDP); Ms. Kerry Adby, Australia (FIDP)]
	Session 4A	**Housing Finance- Best Practices in Public-Private Partnership** Chair: Mr. Md. Matiul Islam, Chairman IIDFC Lead speaker: Mr. R. V. Varma, Executive Director, National Housing Bank, IndiaMr. Juan Costain, Lead Economist, South Asia Region, World Bank
	Session 4B	**Development of Mortgage Backed Securitization** Chair: Mr. Md. Allah Malik Kazemi, Deputy Governor, Bangladesh Bank Lead Speaker: Mr. Martin Essenburg, Global Head of Asset Securitisation, Stan Chart Bank
	Session 5A	**South Asian Experience in Bond Markets Development** Chair: Mr. Khairuzzaman Chowdhury, Chairman, National Board of Revenue Lead speaker: Ms. Usha Thorat, Executive Director, RBI, India
	Session 5B	**Addressing Critical Market Impediments in Bangladesh** Chair: Mr. Syeduzzaman, Chairman, Bank Asia (former Minister for Finance) Lead speaker: Mr. Ziaul Hassan Siddiqui, Bangladesh Bank
		Chief Workshop Coordinators Dr. Shahabuddin M. Hossain, Advisor to the Governor, Bangladesh Bank Mr. Ziaul Hassan Siddiqui, Executive Director, Bangladesh Bank

III. Summary of Discussions of the Workshop

1.A. Developing Market for Government Bonds - Backbone of the Bond Market

Government bonds provide the backbone for bond market and the development of government bonds of different tenors is necessary for development of yield curve needed to provide benchmark for long term lending. In his presentation Dr. A. G. Karunasena, Assistant of the Central Bank of Sri Lanka noted that working out a government borrowing strategy, commencement of market based borrowing to meet the medium and long-term financing needs of the government, developing a conducive legal framework, dissemination of information are some of the critical actions taken to develop yield curve and promote secondary trading of government bonds in Sri Lanka.

Mr. Zafar Shaikh of State Bank of Pakistan, in his presentation observed that the development, dissemination of information regarding debt strategy, issuance cycle and maturity choice, a practice introduced in Pakistan can work to reduce uncertainties and increase market participation. Such a strategy has allowed both Pakistan and Sri-Lanka to increase marketable debt as a portion of total government borrowing sharply in the past two decades.

When the discussion turned to Bangladesh, a number of speakers including Mr. Kazemi outlined the measures taken by the Ministry of Finance and Bangladesh Bank to develop government bond market, including market based auction system, introduction of long-term bonds to develop yield curve and coordination of monetary and fiscal policy. Dr. Shahabuddin M. Hossain pointed out that currently banks hold government bonds largely to meet their Statutory Liquidity Reserve (SLR) and the banks have little incentive to engage in secondary trade of such securities. During discussion it came out that it is necessary to reform the currently dormant Primary Dealer (PD) system - to ensure market making and trading of bonds. Currently, only commercial banks and one financial institution are privy to the primary dealership network. Ms. Usha Thorat of Reserve Bank of India commented that creating separate subsidiary within banks for operations of PD, issuing guidelines on PD activity outlining capital adequacy requirement, marked to market requirement for their trading portfolio, limit on borrowing from call money market and privileges for PDs (e.g., liquidity facility) have proved successful in developing government bond market in India, including development of secondary market and yield curve.

1.B. Market Infrastructure and Secondary Market Development

Drawing experience from Malaysia, India and Sri Lanka, the lead speakers in their presentation highlighted different aspects of the market infrastructure and risk management system for secondary market development. It was pointed out that elements of bond market infrastructure which include effective clearing and settlement system, conducive trading platform, risk management practices are essential for development of secondary market for bonds. In this respect, the commentators from India emphasised the development of a clearing institution and introduction of delivery versus payment system to reduce settlement risks. Effective clearing facility necessitates a strong IT platform to ensure seamless interfaces in the settlement process. Alongside, standardization of accounting norms has also been identified as an essential component to minimizing discrepancies and inconsistencies. Collateralized borrowing and lending operations (CBLO) relating to government securities, as practised in India, also provide flexibility to local fund managers managing liquidity. Risk management practices, which may entail limits on lending and borrowing activity in the local market are necessary for financial discipline.

The discussions and papers presented reiterated the need for building investor confidence as the foremost hurdle to encourage secondary market trading. Efforts to develop such confidence would involve changes in the legal, regulatory, tax frameworks that provide adequate protection to investors and also ensure maximum market participation for issuers. Stamp duties and withholding tax have been overhauled in India in the past decade for this purpose.

2.A. Development of Corporate Debt Instruments-Historical Perspective

Mr. Khandker, the MD of ICB in his presentation noted that despite existence of guidelines governing the public issue of debentures (which has the characteristics of corporate bonds) since 1947, the first debenture was not issued until 40 years later in Bangladesh. In the almost 20 years that have followed, only 19 debentures have been issued. Perhaps even more appallingly, of these 19 only 7 have been successfully redeemed and others have failed to honour interest and principal payments.

Several elements have contributed to this trend. The lack of a dedicated regulatory framework governing the bond markets, in part, led to the default culture that prevailed. The failure of supervisory and law-enforcing bodies such as the SEC and the Investment Corporation of Bangladesh (ICB) in their capacity as trustee have in turn, stymied investor confidence. Legislation barring entrance of major fund managers, such as pension funds and insurance companies, is another element in this regard. Prohibitively high issuance costs, reaching an average of 7-8% of issue size, and relevant disclosure and compliance procedures have only promoted further disinclination of issuers to approach the bond market for financing. Asides from such direct deterrents, the bond markets have also been hindered by high returns on government national savings instruments, high bank deposit rates, which have reduced the overall attractiveness of bonds.

During discussions, one participant from Sri Lanka pointed out that the promotion of an effective trustee, distinct from the ICB, would be a significant step towards this end. In Sri Lanka, moves to award trusteeship to several foreign, well-respected banks have stimulated investor confidence greatly.

2.B Building Investor Confidence - The Role of Rating Agencies

In his presentation Mr. Ravimohan of CRISIL India Ltd. outlined the evolution of Indian fixed income market, investors' preference for highest safety ratings, and role of rating agencies in building investors' confidence and the background and activities of the CRISIL Ltd. in this regard. The role of efficient and reliable rating agencies is indispensable in obliterating uncertainty and hesitation in investors. Ratings makes possible improved funding flexibility and greater access to finance for investors; on the other hand, ratings allow investors to value securities, price risk premium more accurately and help in portfolio monitoring, adjustment and allocation. In essence, ratings are essential for investor protection and market discipline. The discussants pointed out that the focus should not only be on debt service and quality of rating service is very important. In the Bangladesh context activities of the lone rating agency was discussed and some speakers welcomed the appearance of second rating agency and highlighted the need for supervising the entities.

3. Securitization in Bangladesh: Scope and Opportunities and Structuring Issues

While discussing scope and opportunities of securitization, the lead speaker noted that securitization is a method for using the predictable cash flows from receivables (mortgage debt, leases, loans, credit card balances etc.) as the basis for issuing debt. It involves producing securities or investment instruments, which are supported by specific assets. These are called asset backed securities. It was pointed out that although the bond markets remain shallow and illiquid, the launch of the first asset-backed securitization in

Bangladesh is a testament to the capability of public-private sector partnership in promoting financial product development and engineering. Most importantly, it illustrates the capacity of private NBFIs, local legal counsel, regulators and Bangladesh Bank to work in unison for financial and economic development. It was noted that despite some hurdles there exists many opportunities for securitization and market participants have to take advantage of that.

The lead speaker from India noted that securitization, although a novelty in Bangladesh, has achieved massive popularity in the world and is currently riding a wave of momentum in the Indian sub-continent. In fact, between 2002 and 2005, India's Asset Backed Securitization volume has grown by a staggering 151% (estimated) while Mortgage Backed Securitization is expected to evolve at a phenomenal 261% (estimated) within the same time period. As a financial product, securitization has gained popularity for providing a method of issuing bonds that ensures maximum safety for investors. Securitization can also circumvent the restrictions placed on bank lending by the size of their balance sheets. Most importantly, securitization addresses the fundamental asset liability maturity mismatch problem by providing true long term funds.

While discussing collateral and structuring issues, the lead speakers pointed out that despite the launch of securitization by IPDC in November 2004, impediments to its unabated development remain. Developing some market infrastructure and amendments to the regulatory framework are indispensable in this respect. These could involve a specific law governing the process of securitization, ensuring true remoteness of SPV from originator to prevent any conflict of interest or problems occurring from originator's insolvency. Laws that enable the transfer of underlying collateral will also facilitate the growth of this new market. Bangladesh government has already passed measures to provide capital relief to issuers by reducing stamp duty. Investors are further encouraged by attractive reductions in tax on interest income derived from these zero coupon bonds (ZCBs). However, such preferential tax treatment available only for securitization may also prove detrimental to the development of corporate bonds.

4. Housing Finance and Mortgage Backed Securities

In Session A the presentation by lead speakers and the discussion covered broader issues relating to house building finance practices in Bangladesh, the public-private partnership model practiced in India and elsewhere along with prescriptions for developing deep, liquid mortgage markets with long-term capital funding. The discussion emphasized the need for the transition of housing sector from a social to economic one. This is especially important in light of the changing demography and rapid urbanization in South Asia where housing finance is traditionally dominated by inefficient state-owned monopoly. The discussion highlighted the experience of other developing and developed countries in developing a mortgage market as a vehicle of wider home ownership.

In light of the existing scenario, the possibility of mortgage backed securitization was also considered by participants in Session B. This is mainly because the asset-liability maturity mismatch is perhaps most acute in this sector where assets developed are long term in nature, exceeding 15-20 years, while liabilities structure is still dominated by 1 year retail bank deposits. In Bangladesh, housing finance market has enjoyed the entrance of several specialised institutions and banks but market penetration remains only 1.5% compared to, for example, 50% in the United States. The entrance of these participants has been particularly welcomed as existing government housing finance institutions have suffered from unwieldy loan sanction processes, poor recovery rates. Even private sector participants regularly encounter lengthy recovery system, title deed and recording systems, which delay transfer processes and have also been identified as key obstacles to securitization.

5. South Asian Experience: Legal and Regulatory Framework and Critical Market Impediments

The lead speakers noted that while a dedicated legal and regulatory framework is essential for the unhindered development of bond markets, its development goes hand in hand with market development. On one hand too much regulation can only serve to burden all stakeholders and on the other hand too little can also result in misuse and loss of confidence. Legal frameworks may involve constitutional acts, as followed in India, limiting borrowing within budgetary regulation, as well as regulation of banks for uniform valuation of securities and uniform accounting standards by different financial institutions. In this respect, the observance of international best practices such as IOSCO Principles in investor protection, transparent markets and reduction of systematic risk will serve to strengthen regulatory frameworks greatly.

A number of speakers including the Chair of Session 5A pointed that while the imperatives for bond market development and several in number, the government has already made strides to initiate this process. Some of the most significant actions include the reduction and rationalisation of interest rates on government savings instruments, introduction of waivers in terms of stamp duties and VAT on Special Purpose Vehicles (SPV), reduction of income tax for interest income derived from zero coupon bonds to 10%, introduction of 5, 10 year treasury bonds to facilitate the development of long term benchmark yield curve etc. In this respect, the government has attained a multi-pronged approach to encourage investor participation.

To promote bond market development and securitization, the lead speaker in Session B Mr. Z. H. Siddiqui, of Bangladesh Bank highlighted the need for further rationalization of tax structure and tax neutrality, introduction of credit ratings, amendment of Money Loan Court Act to allow investors of financial instrument to seek recourse in case of default, need for developing local expertise particularly on legal issues.

IV. Policy Recommendations

Some of the major policy recommendations captured at the bond conference are:

a. <u>Government Bonds</u>:

i. *Primary Dealership (PD) system:* Currently PDs do not engage in secondary trade and therefore cannot play the role of market makers that PDs are intended to. Therefore, to address these problems it is imperative to:

- Introduce marked to market requirement for the trading portfolio of bonds.
- ensure two-way quotes by dealers at all times
- ensure privileges and incentives for PDs to trade; provide liquidity facility to PDs
- increase pool of PDs to increase competition, skill and experience
- consideration may be given to create separate subsidiary within banks with separate capital requirement and guidelines for treasury operations.

ii. *Debt Strategy, Issue Cycle and Maturity Choice:* A long-term debt strategy provides advance information about borrowing requirements smoothing out uncertainty. In this respect, the following steps should be taken:

- establishment and adherence to government medium term debt strategy through enactment of Fiscal Management Responsibility Act
- publication of yearly calendar with auction schedule, size and maturity

- encourage deeper participation of existing bonds maturities (5 year, 10 year) before introducing longer tenure bonds (15 year).

b. Market Infrastructure, Settlement Systems and Secondary Market Development:

In Bangladesh, the present market is highly segmented with poor transaction record between banks owing to settlement risks. Incentives and orientation for secondary trading itself low. Some of the reform measures include:

- Clearing institutions which may be owned by all financial institutions to reduce settlement risks may be introduced in the long term while in the medium term, real time gross settlements (RTGS) of securities (or delivery vs. payments) may be considered

- Establishment of active treasury management operations and usage of mark -to-market approach for valuation of securities

- CBLO operations government securities as practised in India can serve to add flexibility and efficiency in managing liquidity

- Development of an effective inter-bank money market and a benchmark money market rate will also help secondary trading

- Guidelines for risk management of banks and NBFIs should be introduced

- Appropriate legal and regulatory framework for issuance and trading of bonds should be established specifying such issues as legal basis of depository, electronic transfers, multilateral netting etc.

- Presence and encouragement of the use of rating agencies in providing clear, concise analysis that helps protect investors and price risk premium effectively.

c. Legal, Regulatory and Tax Issues:

Bangladesh still has considerable groundwork left to do to nurture a legal, regulatory and tax environment to protect investors and issuers' interest simultaneously. Further reforms include:

- Fiscal responsibility Act from the government to imbibe maximum discipline into borrowing policies within the current budgetary framework

- Legal recognition of repos, derivatives, short selling as well

- Legislation allowing the entrance of major market players such as insurance companies and mutual funds to invest in bond markets

- Lower stamp duty for securities issued in demat form as well as other preferential tax treatment for mutual funds, government securities and other tradable debt securities for a stipulated period only

- Mandatory use of ratings to disseminate information about default record and other important parameters

d. Securitization:

- Enactment of legislation regarding the transfer of underlying collateral which is not currently permitted by law

- Arranging recourse in case of default to the Money Loan Courts by investors of financial instruments which is again not permitted by law

- Encouraging the original format of securitization to flourish - i.e, through the functions of the distinct SPV, originator and servicer entities.