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Financing Long Term Investments in Bangladesh: Capital Market Development Issues

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CONTENTS

1. Introduction

At its present level of development, it is important for Bangladesh to identify alternative ways of financing investments, especially relatively long term and lumpy investments such as electricity, power, and other infrastructure facilities. With current emphasis on increasing the role of the private sector in financing such investments, the development of a sound and vibrant capital market is of prime importance within different constituents of the country's financial system.

Although most of such investments in the past were undertaken in the public sector with foreign financing, two factors point to the need to progressively move toward privately-financed infrastructure projects with greater reliance on the domestic capital market. *First,* there exists an ever increasing gap between the demand for and the supply of finances for such projects which has emerged as a major challenge and is unlikely to be met through public sector efforts alone. *Second,* it may not be prudent to finance such projects through foreign borrowings on a wide scale since most of these investments generate revenue in local currency (Taka). Thus, there is both a scope and a need to develop financial instruments to tap the domestic capital market to finance infrastructure and similar projects. Along with generating additional investment funds, this will also promote better risk sharing, accountability, and financial management.[1]

In most developed countries, projects having long term financing needs (like in the infrastructure sector) usually raise funds from institutional investors, such as insurance companies, pension funds, endowments, and similar other sources. In Bangladesh also, saving institutions that have typical long-term liabilities can become the prime source of financing long term projects. In this context, the development of an active market for securitized corporate debt, mutual funds, and other financial instruments is necessary where both banks and non bank financial institutions (NBFIs) can play the role of large investors. Thus within the current structure of the financial sector, the development of a vibrant capital market is critical for Bangladesh to finance the new generation of long term investments needed to promote higher growth and attain other development goals. This will also be the key to providing mechanisms of ensuring greater liquidity and minimizing risks in the financial markets. So far the equity market seems to have developed at a faster pace in terms of liquidity, regulatory framework, and other operational

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[1] The size and composition of Bangladesh's financial sector is small relative to other South Asian countries. In June 2008, the share of outstanding volume of bond (including government treasury bills) in the country's GDP was only 5.5 percent compared with 43.4 percent in India, 29.8 percent in Pakistan, and 39.5 percent in Sri Lanka. The share of Bangladesh bond market in South Asia was only 1.9 percent in 2006 which was 85.6 percent for India, 8.5 percent for Pakistan, 3.6 percent for Sri Lanka, and 0.3 percent for Nepal.

procedures along with turnover and market capitalization while the long term debt market has lagged behind.[2]

The above calls for measures to develop the country's debt market since the primary role of the banking system should be to ensure liquidity to finance short term production since undue reliance on banks as the source of long term investment capital creates liquidity mismatch and makes the economy vulnerable to external shocks. In view of the increasingly volatile nature of financial markets around the world, Bangladesh needs to ensure an expanding debt market that would permit greater reliance on bond financing thereby reducing macroeconomic vulnerability and systemic risks through diversification of investment and credit risks.[3] This paper analyzes recent developments in the country's capital market and suggests measures to ensure a liquid capital market in Bangladesh to support the country's rapid development needs.

2. Pre-Requisites to Capital Market Development

The development of a well functioning capital market requires the adoption of a process approach, effective implementation of which depends on a number of pre-requisites. The experience of countries having vibrant capital markets shows that, despite country level differences, several features are important in creating a capital market friendly environment:

- A relatively large and expanding private sector with reliance on market provision of financing through equity and debt instruments.
- Integrated financial market having deregulated interest rates.
- Well developed government securities market providing benchmark yield curve for pricing of bonds.
- Quality outputs from credit rating agencies that avoid mispricing of risks along with institutional and legal frameworks to ensure that outputs do not get contaminated.
- Efficient clearing and settlement systems and well functioning depository system.
- Well articulated regulatory framework with laws to provide regulatory oversight and investor protection and ensure required disclosure, accounting standards, and governance.
- Transparent and well conceived government policy on bond market development.

[2] In this paper, debt market refers to corporate debt market which is essential to meet the requirements of the corporate sector for long term capital investment and asset creation.

[3] Moreover, raising funds through issuing bond may be more preferable to investors since company owners traditionally prefer to retain individual/group ownership.

In terms of the above requisites, Bangladesh's position is mixed. Although the country has a growing government securities market, it is yet to provide a dependable yield curve. The stock exchanges have created trading platforms for debt securities and the depository system is working well at present. The settlement system has improved in recent years; settlement of government securities now involves a delivery versus payment system and equity settlement cycle has been reduced. Efforts are underway to operate real time gross settlement for commercial bank transactions. Several rating agencies are working with good track records. The Securities and Exchange Commission (SEC) and Bangladesh Bank (BB) have taken steps to develop the market and improve transparency through enacting prudent regulations such as prescribing disclosure requirements for private placement by listed companies, compulsory holding of securities in dematerialized forms, and mandating the use of the order matching system of stock exchanges. More efforts, however, are needed in settling legal, regulatory, tax, and design issues in developing the corporate bond and securitization market.

In practice, three systems are available for public offering in the bourses. The traditional one is auction (that is, direct listing method) which helps owners to divest their shares for making their issue listed in the bourse to obtain its market value.[4] The second option is fixed price initial public offering (IPO) for raising fund and getting listed in the bourse. The third option is book building method in which the market determines the value of the shares and the benefit accrues to the issuer company. Under this option, any excess over the offered value goes to company reserve instead of raising the paid up capital enabling the company to expand production over pre-offered capacity. With proper planning, this enables the investors to rip more benefit and hence helps inject effective momentum in the market. Under the system, big companies are encouraged to go public and investors are more induced to participate in the secondary market.

3. Recent Developments

In the presence of a bank-dominated financial system where the dependence on bank loan is substantial, Bangladesh's capital market is small and has a heterogeneous composition compared with developed and well functioning capital markets. As a result, the debt market has played a minor role in investment financing in Bangladesh even in recent years. In FY08, the amount of industrial term loans disbursed by banks and NBFIs stood at Tk 201.5 billion (of which the amount disbursed by NBFIs was Tk. 23.9 billion) compared with only Tk. 6.9 billion by new capital issues through private placements, public offerings, and right offerings in the capital market.[5] This indicates the

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[4] This window is most suitable for the government to off load their shares to general public and find strategic partner for sharing management for better efficiency, transparency, and accountability and creating public limited companies.

[5] See, *Bangladesh Bank Quarterly,* various issues, Bangladesh Bank and *Monthly Review,* Dhaka Stock Exchange.

overwhelming preference of bank finance in industrial investment financing. Such high dominance of term loans in bank financing implies low equity stake and high risk exposure on lending banks and financial institutions, including liquidity risk arising from funding of long term loans with relatively short term deposits. This shows that Bangladesh has a financial system which is highly dominated by the banks.

Despite the limited role of the capital market, the securities market has shown notable progress, with upward trends in all share price indexes, turnover values, and market capitalization. The total market capitalization at the Dhaka Stock Exchange (DSE) reached Tk. 965 billion in June 2008, which is nearly 18 percent of the country's GDP compared with 16 percent in June 2007. A major weakness of the market, however, is its inability to reflect the company fundamentals adequately along with the danger of inside trading in manipulating market prices. For sustained development, it is also important to reduce volatility in the market which has shown increasing trend in recent years.[6] The development of the secondary bond market is required for reducing the undue price volatility in the stock market.

Table 1: Indicators of Capital Market Development

	FY03	FY04	FY05	FY06	FY07	FY08
Securities Market (DSE)						
Number of listed securities*	60	267	259	277	281	294
Issued equity and debt (billion Tk)	36.1	46.8	52.8	64.7	83.7	109.0
Market capitalization (billion Tk)	69.2	142.4	213.0	205.3	412.2	964.9
Turnover (billion Tk)	30.6	24.8	74.1	46.0	164.7	543.2
General price index	830	1,319	1,713	1,340	2,149	3.001
Listed Mutual Funds						
Number of mutual funds	10	11	12	13	14	14
Market capitalization (billion Tk)	0.5	0.8	1.3	1.2	3.3	9.5
Bond Market						
Number of listed bonds	8	8	26	34	52	93
Government	…	…	18	26	44	84
Corporate	…	…	…	…	…	1
Debenture	8	8	8	8	8	8
Market capital (billion Tk)	0.5	0.5	12.2	20.6	80.2	178.9

Note: * include debentures but exclude government bonds. Of the total number, 231 are listed in Chittagong Stock Exchange (CSE) as well. There are only 4 securities which are listed in CSE but not in DSE.
Source: *Monthly Review,* various issues, Dhaka Stock Exchange.

6 The price-earning (P/E) ratio of DSE shares increased to 22.8 in June 2008 from 12.1 in December 2007 and 17.3 in June 2007. From the perspective of the investors, a higher P/E ratio is risky since this may be due to the fact that current prices do not reflect company fundamentals raising the possibility of price fall in future. The average volatility of DSI, as measured by standard deviation, was recorded at 46.2 in FY08 which shows significant rise over earlier years. See, *Financial Sector Review,* 3(2), Bangladesh Bank, June 2008.

Although mutual fund instruments provide a relatively safe and profitable investment in the capital market allowing the investors to derive the benefit of lower transaction costs and hold more diversified portfolios, the number of mutual funds is small having low issued capital. There were only 17 mutual funds (of which 14 are listed in DSE and the other three are open ended) in FY08 having a share of less than one percent of total market capitalization.[7] The market price of all mutual funds persistently increased in recent years along with high price-earning ratios reflecting growing demand and widening mismatch between demand and supply. One of the factors that explain the good performance of mutual funds is the provision for reserve of 10 percent quota of each IPO for mutual funds. Despite bright prospects of mobilizing savings and providing investment opportunities to small savers and the ability to meet different risk profiles through providing a wide range of products, one major factor as to why the mutual funds have not emerged as a preferred saving mode is the lack of availability of quality shares and the underdeveloped state of the capital market.

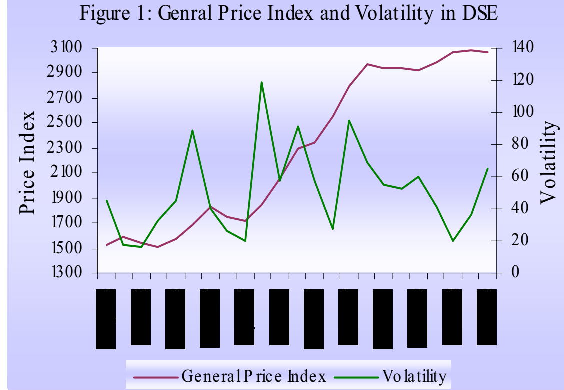

Figure 1: Genral Price Index and Volatility in DSE

Like in any other country, a well-developed tradable bond market is critical to ensuring stability and efficiency of the financial market in Bangladesh. An efficient bond market is important for managing public debt and bank liquidity and for efficient conduct of the monetary policy. So far the bond market has played a limited role in the economy. The country's financial sector is dominated by the commercial banks. Most of the country's available saving is held by the banks in the form of deposits and channeled through lending to the investors. The dominance of banks, with high bad loan portfolios and non-transferability of most of their debt/savings instruments, acts as a prime hindrance to the development of a well-performing bond market. The absence of such a market makes the financial market less competitive as it fails to generate market interest rates that reflect the opportunity cost of funds at different maturities and results in excessive reliance on the banking system.

In recent years, around 70 percent of the domestic savings are held in the form of bank deposits, while only 30 percent are investments in the debt market which is entirely dominated by government instruments.[8] There hardly

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[7] Two more mutual funds (ICB AMCL 2nd NRB and Grameen One Scheme Two) were listed in DSE in August/September 2008.

[8] Among these, NSD certificates occupy more than three-fifths of the total invested capital and the remaining portion is shared by treasury bills and BGTB. See, *Financial Sector Review*, 2(2), Bangladesh Bank, June 2007.

exists a corporate bond market in the country; it has a debenture market with only a small number of well-known issuers.[9] Till FY08, only one corporate bond has been floated.[10]

The debt market in the country is primary auction-based; and all activities related to issuance of government debt are done through primary auctions conducted by the Bangladesh Bank (BB). The primary issue of government bonds, however, does not indicate the existence of a deep and liquid market in the absence of active secondary trading.[11] In principle, the primary dealers (PDs) can play an important role to activate the secondary market of treasury bills and government securities through enhancing its liquidity and depth by facilitating price discovery and turnover, encouraging voluntary holding, and developing underwriting and market making capabilities.[12] Moreover, with the domination of only short and long term government securities and a nascent corporate bond market having only a shallow debenture market, the bond market does not have the varied corporate debt instruments.

Although the NBFIs have an important role in meeting diverse financial needs of different sectors and in deepening the country's financial system, the major business of most NBFIs in Bangladesh is leasing though recently some are diversifying to other activities, such as term lending, housing finance, merchant banking, equity financing, and venture capital financing. Although the activities of NBFIs have witnessed an impressive growth in recent years with an outstanding total business investment of Tk. 94.7 billion at the end of June 2008, these are in a somewhat disadvantageous position in terms of collecting funds compared with the banks. As per regulations, NBFIs are not allowed to collect short term deposits (less than one year) from individuals. The major sources of fund of NBFIs are loans from the banks and deposits from institutions and individuals usually collected at higher deposit rates compared with the banks.[13]

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[9] A total of 17 debentures were issued since 1987 through public offering out of which eight are outstanding at present. However, the liquidity of these debentures at the stock exchange is insignificant and trading is negligible due mainly to their inferior quality.

[10] Since 2001, different NBFIs issued privately placed bonds and asset-backed securities creating high demand from financial institutions especially due to the provision that a withholding tax of 10 percent was taken as the final settlement toward the tax liability of the investor. However, this incentive was discontinued in FY06.

[11] In the DSE, 18 BGTBs were listed in 2005 while another 16 BGTBs got listed in 2006 with a total worth of Tk. 4.5 billion. However, only one 10 year BGTB was transacted on the secondary market since the inception of debt securities in DSE in 2005. Unattractive yields to the investors, provision of taxing interest earnings on treasury bonds, relatively large denomination (Tk. 100,000) for the retail investors, are some of the factors behind dormant trading of existing government securities in the secondary market.

[12] The BB has issued PD license to nine financial institutions, but these are yet to fully start their activity as PD.

[13] These two sources account for nearly three-fourths of the total funds of NBFIs. A recent study shows that the cost of funds of NBFIs varies between 10.5 percent and 12.3 percent whereas similar cost is between 6.4 percent and 8.4 percent for the private commercial

Although Bangladesh's capital market has been experiencing noticeable growth, yet the country's GDP to market capitalization ratio is significantly lower than for comparable countries and the economy's key sectors remain inadequately covered in terms of market participation. Over the years, the market has become stronger no doubt, but it is still characterized by several structural weaknesses and risk factors that constrain its healthy development:

- With strong growth in demand for securities, prices of most securities are also growing making these riskier than their expected return potentials.
- Physical facilities, infrastructure, and market monitoring capacity (including supervision of compliance provisions) are overstretched to support the fast growth of the sector and new investors, entering the market without basic knowledge on the market, run the risk of making wrong investment decisions.
- Inadequate supply of professional analysts to bring out efficient investment insights.
- Slow growth of institutional investment (e.g. mutual and pension funds, professional portfolio manager fund) creating disproportionate dominance of retail investors in the market fueling undue instability.
- Inadequate flow of mutual fund, securities with good fundamentals, and corporate (and government) bonds creating constraints in bringing depth, liquidity, and strength in the market and leading to overpricing of few securities and higher risks for the investors.
- Shaky confidence of investors on private sector debt securities due to weak regulatory regime. In the past, a number of publicly traded debentures issued by corporate houses failed to service interest coupon and principal payment obligations in time.

4. Capital Market Development: Current Initiatives

Considering the prime importance of the capital market in ensuring the stability and efficiency of the country's financial system, measures have been taken in recent years to develop and strengthen the capital market. For activating the country's secondary bond market through revamping the trading of government approved securities in the stock exchanges, BB has created an alternative platform exclusively for the PDs to promote transaction of government bonds. The Securities and Exchange Commission (SEC) provides guidance and encourages selected brokerage firms to participate in activating trade in government bonds. The BB has issued guidelines regarding revaluation of treasury bills and bonds on the basis of marking to market in order to encourage transaction of government

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banks. See, Ahmed, N. and M.I. Chowdhury, *Non Bank Financial Institutions in Bangladesh: An Analytical Review,* Working Paper No. 0709, Policy Analysis Unit, Bangladesh Bank, 2007.

securities after issuance and establish a more effective secondary market.[14] For ensuring more competitive secondary trading of government securities, liquidity facility is provided to PDs against government treasury bills and bonds devolved to them for specified periods (maximum one month) which can be extended for well-performing PDs on the basis of auctions and secondary turnover.

Under the financial sector reform program, several measures aiming to strengthen the term lending practices have been taken including mandatory obligation for all banks to get rated by credit rating agency, replacement of 'general provision (one percent of unclassified loans)' by 'general provision maintained against unclassified loans' in determining capital adequacy for supplementary capital, cognizance of all relevant issues to ensure proper monitoring over credit exposure, and allocation of a minimum of 10 percent of total fund for small and medium enterprises (SMEs) provided by BB to women entrepreneurs.

The BB has taken several measures to broaden the fund base for industrial term lending especially targeted to the SMEs, such as one 100 percent refinance scheme of Tk. 0.5 billion for agro-based industries in rural areas; another refinancing scheme named small enterprise fund (SEF) of Tk. 2.0 billion for banks and financial institutions for financing the development of small enterprises and Tk. 1.6 billion provided by the government for refinancing the development of small enterprises under the enterprises growth and bank modernization program (EGBMP), USD 30 million from Asian Development Bank (ADB) for developing the SME sector; and USD 105.2 million for financing government approved private sector infrastructure projects under investment, promotion, and financing facility (IPFF). The equity and entrepreneurship fund (EEF) with an amount of Tk. 1 billion is also being administered by BB to encourage investments with equity participation in prospective agro-based, food processing, and IT sector projects.

The DSE has also taken up a comprehensive program aiming to develop the capital market. Some measures cover the following:

- Expansion of infrastructure including training academy for turning out market professionals, up-gradation of trading system, and creation of clearing company in addition to the central depository.
- Operationalization of book building process for IPO creating attractive IPO options for big and healthy companies; introduction of index based and stock based futures to ensure greater flexibility, stability, and hedging capability enabling greater diversification of capital market

[14] The banking companies are now required to classify government treasury bills and bonds held by them into held to maturity (HTM) and held for trading (HFT) and adjust their shares of investment in HTM and HFT such that the share of investment in HTM reduces to no more than 25 percent of SLR by January 2011. In general, the banks are now required to hold HTM securities until maturity and are not allowed to reschedule HTM securities into HFT securities.

instruments; and bringing in a credible market structure with required transparency in financial disclosure and corporate governance.

The country's capital market outlook can be improved significantly through creating an enabling environment for quality IPOs. One of the major constraints standing in the way to rapidly increasing the number of new listings is the inefficient pricing mechanism in the presence of poor corporate governance and high cost of listing.

5. Agenda for Action

A fair degree of consensus now exists recognizing the need to develop the capital market especially for financing the country's long term capital investments. For developing the capital market, several weaknesses need priority action which include weak regulatory framework; constraints on the supply side including lack of benchmark bonds and benchmark yield curve, limited interest of financial intermediaries and businesses in launching new debt products; demand side constraints including limited investor base, intermediaries with limited expertise in dealing with debt products, low confidence in corporate borrowers; and market distortions like the ones caused by above market returns offered by the national savings scheme (NSS).

It would be important to address the above and related weaknesses so that the capital market can fulfill the long term borrowing needs of both the public and private sectors. This will make the financial system more competitive through generating market interest rates that would reflect opportunity cost of funds at each maturity and reduce the excess dependence of enterprises on the banking system. For developing an efficient and broader base of the capital market, a robust market of fixed income securities is an essential prerequisite. Despite the marketing of fixed income securities first in 1987 with flotation of debenture by two companies, the market is still shallow playing a marginal role in the development of capital market.[15]

In order to develop the primary market, several actions are needed such as streamlining the IPO approval process and pricing methods and enhancing the capacity of the merchant banks; bringing the legal framework for corporate mergers and acquisition in line with international best practices; relaxing margin lending and borrowing and lending of securities; and introducing products to increase market participation. While the primary market for government securities has improved, the development of the

[15] Trading of government treasury bonds started in December 2005 at the DSE. Till end June 2008, eight debentures (no new debenture was issued after 1999), 84 treasury bonds, and one corporate bond (floated in 2007 named IBBL Mudaraba Perpetual Bond) were traded in the country's capital market.

secondary market is critical to creating a broader bond market in the country. In addition, it is important to improve market supervision and capacity of all major market players; increase the supply of securities, products, and services; ensure transparency in trading and improve quality of information provided by listed companies; and expedite technology adoption in support of market infrastructure. Similarly, strengthening the capacity of the regulators (including SEC to perform both operating and development mandates) and market participants is important in implementing comprehensive capital market reforms.

In addition to strengthening the government bond market, several policy and institutional measures are necessary to expand the base and streamline the functioning of the country's capital market.

Contractual savings

For financing long term investments through the capital market, it is necessary to initiate major reform in the area of contractual savings institutions (CSIs), along with the possibility of allowing the entry of private companies and institutions. In this context, the development of private pension funds should be supported through strengthening of infrastructure and bringing greater transparency in the non-government debt market.

The CSIs can collect household savings that could potentially be channeled into the long term debt market. In most countries, CSIs have typically driven the development of the long term private bond market, since it has a big demand for long term assets with fixed returns. In order to stimulate such development in Bangladesh, it would be necessary to allow the CSIs to invest in a broad range of private debt securities. For this, an important prerequisite would be to effectively regulate the private placement market. A well functioning 'clearing house' is another prerequisite for minimizing risks for which ensuring innovation and increasing the depth and liquidity in the secondary market are also necessary. It may be prudent to permit these institutions to invest in corporate debt based on prudential criteria such that they are able to invest their portfolios in securities having specified credit ratings. These measures would increase the ability of the CSIs to purchase private debt securities in the primary and secondary markets.

Benchmark rates

A well functioning money market is critical to developing the corporate debt market. By providing an anchor at the short end of the yield curve, it serves as a benchmark for pricing other debt securities with differing liquidity, maturity, and credit rating. In the absence of reliable benchmark rates, it is difficult to price long term corporate debt and floating rate debt. At present, there is no clearly defined inter-bank term money structure in the country beyond the overnight rates. Moreover, rationalizing of rates across different assets is necessary as the yield of treasury bills and bonds at different maturities having the same level of risk are low compared with yields of other instruments especially savings certificates.

Clearing and settlement infrastructure

For ensuring sustained growth of the debt market, smooth and secure delivery of securities and settlement of trades are essential. An efficient clearing and settlement system would promote liquidity, transparency, and trading efficiency in the secondary market. For this, credible and secure electronic clearing and settlement arrangements need to be implemented for corporate debt securities. While the introduction of electronic transactions in Dhaka and Chittagong stock exchanges has improved trading in these markets, more efficient and simultaneous transfer of fund and securities (e.g through introducing effective DvP system for government securities) would contribute to ensuring liquidity in the market.

Hedging mechanism

The development of organized future markets promotes liquidity and efficient pricing in the secondary market. The investors are more likely to hold trading portfolios if hedging against interest rate risk is available. In this context, derivative instruments, which have emerged as an important feature of modern financial markets, can play a vital role in managing the risk of underlying securities such as bonds, equity, equity indexes, currency, short term interest rate asset, or liability positions.[16] When hedge vehicles are used as primary instruments, they become risky business and the availability of derivatives can mitigate the risk. If used properly, derivatives are not likely to be more risky than the underlying assets from which these are derived. When used as hedge vehicles, derivatives can enhance returns and reduce risks.

Short selling

Short selling refers to the mechanism of borrowing a security for a limited period of time from the lender and undertaking to return it at some future time according to pre-set conditions. The borrower sells the borrowed security immediately, in effect committing to buy it back in future on the stock market in order to return it to the lender. The arrangement helps the investors, who consider that a particular security is being traded at a high price and anticipate that its price would fall, to operate in the market for this security

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[16] Derivative instruments have a fixed maturity period but uncertain cash flows. As an instrument, the existence and value of a derivative is contingent upon the existence of another instrument or security. The underlying asset could be commodities, equities (stocks), bonds, interest rates, currency, or indexes (such as stock market index or CPI index). Thus derivative means a forward, future, option or any other hybrid contract of pre-determined fixed duration, linked for the purpose of contract fulfillment to the value of a specified real or financial asset or to an index of securities. There are three major classes of derivatives: forwards/futures, options, and swaps.

without holding it. Short selling improves the stock and bond market by enabling the investors to act according to their expectations, increasing the probability of trading security at its economic value.

Although the development of short selling needs to overcome difficult implementation problems, especially from the point of view of accounting procedures and taxation, it increases the potential supply of securities in the market, extends the possibilities of hedging in different financial markets, and provides an important means of damping unusual price rises that are essential to improving the functioning of the capital market.

Securitization

For the investors, securitizing the debt provides an additional source of funds and reduces funding costs. For the financial intermediaries, it enables to overcome asset-liability mismatches. Securitization provides the borrowers with access to funds having elongated maturities while the lenders are able to convert assets into cash to meet repayment obligations. The potential scope for asset-based securitization in Bangladesh remains largely unexplored and appropriate changes in the legal and institutional framework are needed to promote the market. With provisions for adequate legal protection including foreclosure laws for mortgaged-backed securities in place, insurance companies, trusts, and mutual funds can become the major investors in asset-backed securities. Obviously, asset-based securitization can gain momentum only if there is a secondary market for debt in which such instruments can be freely traded. The development of securitization needs to start through developing mortgage backed securities (MBS) as the home ownership market is relatively underserved and the demand for fund is high.

Box 1: Some measures for developing the capital market

- Increase the number of PDs, permit and encourage banks and relevant institutions to set up and ensure efficient working of PD counters to broad base the holding of debt instruments at the retail level.
- Reform the NSS to reflect market realities and transform into an efficient retail program for small investors.
- Exempt inter-bank borrowing from CRR and SLR in order to encourage the emergence of a benchmark meaningful rate following the pattern of LIBOR.
- Use the Bank Rate more actively as a reference and signaling rate.
- Facilitate money market development and enhance government cash and debt management capacity.
- Encourage the banks to convert long term loans including such loans to small and medium enterprises (SMEs) to long term (e.g. ten year) bond and raise fund from the bond market through securitized structured finance. This would ensure faster SME development, discourage loan rescheduling, and minimize default culture. Several Asian countries including Malaysia and South Korea have successfully used similar approaches.
- Target the development of a balanced mix of different bonds (e.g. convertible and perpetual) to meet capitalization needs and avoid dilution effects. The NBFIs may be encouraged to accumulate a part of their loanable funds through issuing bonds and recently corporatized state owned commercial banks (SCBs) may issue

convertible bonds to meet capital deficiency prior to their becoming eligible to enlist their issued common stocks to stock exchanges.

- Explore the possibility of using properly structured debt instruments (especially targeted to nonresident Bangladeshis) to finance power and infrastructure projects and creating common investment funds for garments, textiles, ICT, and agro-processing sectors through specially structured bonds.
- Strengthen the capacity of credit rating agencies.
- Give debt market intermediaries better access to institutional finance and permit foreign institutional investors to invest in dated government securities and T-bills in primary and secondary markets.
- Increase the volume of marketable government securities and strengthen the liquidity of the secondary market in government securities. For instance, the government may offer zero coupon bond (like the US Government E series Bond Issue) that offers discount bonds payable on redemption date 10-20 years from the date of issue. The offer may be with or without interest payable on redemption having discount for non interest bearing bonds listed for secondary market trading. This will enable the investors to buy/sell in the secondary market to adjust their liquidity and minimize risks.
- Ensure effective coordination (preferably install a single regulatory authority) between the debt market related activities of BB and SEC.
- Streamline guidelines on issuing bonds and debentures, reduce issuing and transaction costs, and support the development of asset backed securitization.
- Broaden and diversify the investor base with a broad range of institutions and individual investors for ensuring strong and stable demand in the bond market with varying time horizon, risk preference, and trading motives. Accordingly, measures could be taken in several areas such as reform in the pension fund; strengthening of the insurance sector; more effective participation of state owned enterprises, local and foreign banks, and other institutions as institutional investors; vibrant debt derivative market to foster the development of risk management products (interest rate, credit, and foreign exchange); and use of OTC and stock exchange based market platform.
- Encourage nonresident Bangladeshis to open NITA account and participate in the capital market through easing procedural complexities and redressing other bottlenecks.
- Introduce comprehensive policy to bring the corporate companies to the capital market and depend on corporate culture of mobilizing finance.
- Consider the possibility of developing a single tax deducted at source (TDS) rate for all debt instruments.
- Encourage DFIs and similar institutions to issue specific purpose bonds (such as infrastructure bonds) initially supported by incentives for individual investors, e.g. tax exemptions up to certain limits.
- Initiate actions for developing a municipal bond market.

6. Concluding Remarks

With more emphasis and reliance on the private sector for stimulating investment and growth, and especially with the rapid increase in demand for infrastructure services and opening up of the infrastructure sector for private investment, a larger number of financial intermediaries and private sector participants would enter the financial market to raise long term funds in Bangladesh. Moreover, the demand for long term funds through bonds is likely to come from different types of private entrepreneurs, such as independent power producers (IPPs), telecom companies, and the like. It is important, therefore, to set up the required debt market infrastructure that can create a vibrant secondary debt market in Bangladesh. The policies must also focus on developing a class of institutional investors who are capable of providing funds with relatively long term tenures such as from life insurance and pension funds. This will enable the households to get better returns for their savings along with creating wider choices for the institutional investors.

In the context of the present global financial crisis, the important lesson is to ensure good risk management for capital market institutions and for the entire financial system. For an institution, a good risk management system should enable it to take risks and reap the returns ensuring exit at the first opportunity if the situation demands. The experience also shows that there is no substitute of prudent government intervention and careful regulation even when market determined incentive structures operate. The pursuit of free financial sector nostrums does not guarantee against moral hazard, adverse selection, and the financial institutions to cause systemic distress. This does not, however, mean that the financial sector should be administratively controlled and not be allowed the freedom to innovate, compete, and use market based incentives. A liberalized, market based, and effectively supervised and regulated financial sector is necessary in order to promote and sustain rapid growth in the capital market in Bangladesh.

In addition, the priority for Bangladesh is to improve the quality of information that the capital market and related institutions put out and those collected by the regulatory agencies. Clearly, Bangladesh needs to plug the gaps in regulatory and supervisory infrastructures and strengthen its regulatory regime in a comprehensive manner covering all institutions dealing with both household savers and institutional investors in order to avoid the creation of any systemic distress.

The current reforms for developing the financial markets by the Bangladesh Bank and other authorities, although focus more on the government securities market, are no doubt important steps from the point of view of creating appropriate market infrastructure and should be taken forward toward creating a vibrant capital market having a growing non-government segment as well. Obviously, a number of impediments stand in the way of developing the capital market covering legal and financial infrastructure issues, regulatory issues inhibiting the development of different corporate debt instruments and entrance of major market players in the bond market, building investor confidence and base, introducing different types of assets including housing finance and mortgage backed securitization, and developing an effective inter-bank money market and benchmark rates to assist secondary trading. Moreover, several key elements of bond market infrastructure need attention including effective clearing and settlement system, conducive trading platform, standardization of accounting norms and uniform valuation of securities, observance of international best practices such as IOSCO principles in investor protection, and ensuring transparent markets and systematic risk reduction which would contribute greatly toward strengthening the regulatory framework.