# NON-LENDING TECHNICAL ASSISTANCE ON CAPITAL MARKETS (P125469)

## CAPITAL MARKETS STABILITY NOTE – A PLAN OF ACTION

**The Bangladesh stock market experienced significant volatility in late 2010 and early 2011 which took stock values high above fundamentals and threatened the stability of the financial system.** This note takes a systematic look at the capital markets underpinnings in Bangladesh, including the regulatory framework, the rule-making bodies and enforcement issues. It also addresses systemic weaknesses responsible for market instability which was observed at the end of 2010 and early 2011. The note analyses the legal and regulatory framework and the SEC enforcement powers, resources and capacity, and outlines specific areas of potential vulnerabilities of securities markets, as assessed against appropriate practice guidelines for stability, sustainability, transparency, and enforcement. A plan of action going forward is also suggested. This note draws on a considerable amount of prior analytical work.[1]

## Macroeconomic and financial sector background

**Bangladesh has sustained a good track record for growth and development in the past decade, which is deteriorating in the past 6 months.** The economy has grown by nearly 6 percent per annum since 2000, accompanied by significant poverty reduction and rapid progress on social transformation and human development. While the outlook for FY2011 still foresees 6.7 percent growth, inflationary pressures have strengthened and the external position has weakened. Consumer Price Index (CPI) reached 10.7 percent in April 2011, and growth in money and credit is estimated to remain high in FY11. Both exports and imports rose in the first part of FY2011 while remittance growth fell sharply, thus narrowing the external current account surplus.[2] Growth in cumulative remittances in the first 11 months of FY11 was around 5.1 percent, significantly below the 15 percent growth seen during the same period the previous year. Short-term risks include rising food and fuel prices, decreasing level of remittance inflows, falling foreign exchange reserves, mounting losses in SOEs creating a growing quasi-fiscal deficit and rising government borrowing from the commercial banking sector, stock market volatility and its potential impact on the financial system. Long-term risks include the inability to sufficiently alleviate power shortages, raise public investment, and remove bottlenecks to private investment.

**Enabling accelerated and inclusive growth is predicated both on the stability of the financial sector, and on its ability to channel long-term funding into areas of productive investment.** To sustain this high growth in Bangladesh, capital accumulation led by the private sector and total factor productivity increases are needed. Private investment, at less than 20 percent of GDP, remains significantly lower than high-growth countries such as India or those in East Asia, and will fail to deliver the planned annual growth of around 8 percent. In large part,

[1] This includes the BHBFC Diagnostic Study 2008, Bond Markets Study 2008, Bangladesh Corporate Governance Country Assessment 2009, IOSCO Assessment 2009, the joint Bank-Fund Financial Sector Assessment 2009, etc.

[2] In value terms, cumulative exports had risen by 41 percent by April 2011 from 4 percent the year before. Cumulative imports rose in value terms by 41 percent in FY11( July-Mar), well above the 5.4 percent growth recorded in FY2010. Cumulative capital imports rose by 29 percent in FY 2011(July- Mar) compared to 6 percent in FY10.

the system's growth is constrained by the twin obstacles of financial system rigidities, as well as infrastructure and power shortages, in turn largely caused by the lack of long-term financing in the system. Specifically, both primary and secondary financial markets have been falling short of providing funding to under-serviced areas of the economy. Primary markets have been focused on traditional banking clients, avoiding riskier clients such as MSMEs, which require innovative service approaches, even though MSMEs are more productive and generate more jobs. Non-banking financial institutions have been more successful in innovating and expanding to new clients, but have been constrained in funding, as securities markets have been underdeveloped.

**The soundness and efficiency of the financial system in Bangladesh have improved as evaluated by the 2009 FSAP, but financial stability has been tested by the recent capital markets volatility.** Total assets of the banking sector have increased twofold since 2003 and credit to the private sector has risen threefold. Domestic private banks now hold around 60% of banking sector assets, and the role of State-owned Commercial Banks (SCBs) and specialized banks has correspondingly declined. Banking sector penetration has increased and branch networks have expanded. Non-performing loans have decreased steadily from around 20% in 2003 to below 9% in 2010 and the stated capital position of banks has strengthened. Substantial improvement in the payments system is anticipated with the forthcoming introduction of an electronic check clearing system and the commitment to introducing an RTGS system in the future. However, reforms have stalled since 2009 and Bangladesh is lagging in development of its financial system, particularly capital market development. The gyrations in stock market prices in late 2010 and 2011 clearly demonstrate the need for a stronger institutional framework, better regulation, and stricter enforcement in the area of securities markets, as well as the banking sector.

**Stock and bond markets have remained under-developed, partly due to the absence of a functional government debt market. The poor depth and breadth of securities markets, combined with an unstable regulatory and institutional framework and weak enforcement by the SEC, makes markets prone to volatility.** Capital markets have not managed to direct long-maturity resources from the contributory sectors such as pensions and insurance to sectors in need of long term finance. As a result, there are no mechanisms – such as covered bonds, refinancing facilities, and securitization – to replenish long-term funding for financial institutions at sustainable rates, freeing resources to allow for scaled-up lending. The challenges are several. First, Government securities are illiquid, and traded almost entirely on the over-the-counter phone market, usually bilaterally between banks (outright trades account for 8% of the $280 million average daily volume). The hampered development of a secondary market in government bonds prevents the formation of a reliable yield-curve, the growth of a private bond market, and the creation of secondary markets for risk management. Second, the corporate bond market is practically non-existent, with two corporate bonds issued (raising $63,000), and 8 private placements of debentures. Under-developed bond markets have been a strong constraint to the liquidity management of lenders, even for smaller banks that mostly rely on deposits. Thirdly, the stock market is poorly regulated which is a high risk to financial stability. A considerable number of companies remain outside of the disclosure regime (the "Z" companies), threatening the congruity of the stock market. Rules against insider trading and related party transactions are weak, as are disclosure of control, corporate board effectiveness provisions, and general standards of accounting and auditing, enabling speculative demand. Enforcement is also weak.

## Capital Markets Overview and Analysis

**Bangladesh capital markets remain ineffective.** The government debt securities markets are illiquid preventing the Bangladesh financial system from relying on a market-based yield curve. Corporate bond markets are nascent, as firms raise money from the banking sector at lower costs. The stock market is poorly regulated and carries risk for financial stability. Below, capital markets are overviewed in turn in terms of level of development, activity, and functioning.

**Bangladesh has yet to develop an active money market.** Its money market consists mainly of a thin interbank market with sporadic trading in treasury bills. Trading of treasury bills in the secondary market is limited because these instruments, along with treasury bonds, make up the statutory liquidity reserve and are therefore generally held until maturity by commercial banks and other financial institutions. Commercial banks and nonbank financial institutions access the call money market to bridge overnight funding gaps or park surplus liquidity. The call money rates are negotiated and tend to be seasonally volatile. Bangladesh Bank monitors the day-to-day liquidity position and eases any substantial volatility in the call money market. Bangladesh Bank offers a repo facility, used as a monetary policy tool, allowing investors to borrow against treasury bills for up to 90 percent of their value. In reverse repo transactions a bank or financial institution that has excess liquidity can deposit it with Bangladesh Bank. The interbank repo market, introduced in July 2003, has not been active. Trading is also thin in repurchase agreements,[3] for two main reasons. First, commercial banks have a weak treasury function, and most do not actively manage liquidity. Second, there is no standard master repurchase agreement, a gap that should be addressed to support orderly development of the repo market.

**Government debt securities remain illiquid.** The Bangladesh government raises funding through treasury bills (364 days), treasury bonds, National Investment Bonds,[4] and national savings certificates, the latter making up for two-thirds of government funding (Tk 650 billion at the end of February 2011). Government debt securities overwhelmingly dominate the market (amounting to to $6.9 billion, or 7.7 percent of GDP) but non-marketable national savings certificates account for an even larger share of domestic savings that are invested in debt instruments. Bangladesh Bank also issues an Islamic Bond of 6 months, 1 year, and 2 years, designed to provide Islamic banks and financial institutions with a Shari'ah-compliant investment instrument. At the end of March 2011 the total sales of this bond amounted to Tk 26.7 billion. The transparency of the primary market in government debt securities has improved in recent years, though primary dealership is in need of reform, and the investor base is narrow and shallow composed of commercial banks and two state-owned insurance companies. Currently, government securities with maturities of 5, 10, 15 and 20 years are listed on the DSE and dematerialized in the Central Depository of Bangladesh Ltd. (CDBL). For T-Bills, the CDBL has provided the infrastructure for BB's electronic registry and has linked up all banks participating in T-bill auctions to the Central Depository System (CDS) of CDBL. Trading in T-Bonds is almost entirely an over-the-counter phone market mainly between banks and is settled bilaterally in the depository. Reasons for the dormant market in treasury bonds include the taxation of interest earnings and, for retail investors, the large denominations. The majority of

[3] Commitments by the seller to the buyer to repurchase the instrument when the buyer intends to sell, or repos.

[4] National Investment Bonds, with a maturity of three years, have offered rates below market expectations, and are held exclusively by life insurance companies to meet their reserve requirements.

secondary market activities of Bangladeshi government securities is repos (see money market section below), with outright trades accounting for only 8% of an approximately BDT 20 billion daily average volume. Experiments with ABS backed by microfinance loans as well as SME loans have had limited effect.

**The corporate bond market is underdeveloped.** The corporate bond market is practically non-existent, accounting for about 19 percent of financial system assets in 2010, the smallest in South Asia relative to GDP. Three corporate bonds and 8 privately placed debentures amount to a further $0.1 billion. Lack of varied corporate debt supply is a major impediment to its development. As in other South Asian countries, corporate borrowers raise bank funds, which is at a lower cost and with less disclosure. The slow growth of the Bangladesh bond market can also be attributed to a lack of benchmark bonds and market distortions caused by the national savings scheme. Under-developed bond markets have not allowed financial term transformation, i.e. matching resources of the contributory sectors (pensions, insurance) to long-term funding needs for infrastructure, housing, and corporate finance. This is a strong constraint to the liquidity management of lenders, even those that mostly rely on deposits. For housing, this precludes fixed rate lending, exposing borrowers to interest rate risk. Development of the bond market, perhaps starting with development of the commercial paper market, is important for long-term debt finance for development. The market has potential for growth in in bank and infrastructure bonds,[5] but faces multiple constraints. The scarcity of both issuers and investors lower liquiduty of the paper. Investors have a buy-and-hold mentality, and place little confidence in the market regulatory framework.[6] The quality of some of the instruments is inferior. Bond issuance costs are high – the registration fee, stamp duties, annual trustee fees on outstanding amounts, and ancillary charges have stifled demand. Registration fees for debentures, however, have been significantly reduced in recent years to ease this burden. Three credit rating agencies operate in Bangladesh.

**There are few long-term funding institutions capable of taking on the demand side of private debt markets.** In Bangladesh commercial banks and institutional investors—life insurance companies, and pension and provident funds—are captive investors in government securities, a result of their need to comply with mandatory reserve requirements or investment restrictions. Commercial banks, along with Bangladesh Bank, dominate the holdings of marketable government securities.[7] Life and non-life insurance penetration remains below 1 percent, which compares poorly with the average for South Asia, though life insurance has been on the increase in recent years, and can become a potentially important institutional investor.[8] Public pension schemes, which are mainly unfunded, dominate the pension fund industry, and required to invest 75 percent of their assets in government securities.[9] State-owned enterprises

[5] One potential source for financing these infrastructure projects through bond issues is the remittances from nonresident Bangladeshis working abroad (currently standing at around $10 billion (March 2011).

[6] This is a result of a failure by issuers to meet contractual payment terms, a failure by trustees to enforce debenture holders' rights, and a failure by market regulators to discipline firms listed on the exchanges for not complying with the contractual terms of the debentures issued.

[7] The statutory liquidity requirements for commercial banks are the biggest driver of demand for government securities. Banks must maintain liquidity reserves of 18.5 percent: 13 percent in eligible assets such as government securities and 5.5 percent in cash.

[8] Life insurance companies are required to maintain statutory reserves of 30 percent in cash, treasury bills, treasury bonds, and National Investment Bonds.

[9] In Bangladesh only 5–10 percent of workers, primarily civil servants, are covered by formal retirement plans.

and nationalized commercial banks also offer retirement plans, though no consolidated data are available on these plans. The pension schemes of large private firms have traditionally invested in national savings certificates. The mutual fund industry in Bangladesh remains poorly developed, though it is tax-favored, perhaps because the capital market is still small and lacks an adequate number of good-quality securities. As of April 2011 there were 33 mutual funds, with a total market capitalization of Tk. 34.33 billion. Of these, eight are managed by the government-owned Investment Corporation of Bangladesh, which holds a large part of the shares on the Dhaka Stock Exchange. With few private institutional investors, the investor base remains undiversified.

**Government securities do not offer competitive returns, while NSS instruments crowd out private bonds.** Neither mutual funds nor foreign investors have shown much interest in investing in government securities. The yields of government securities appear to be relatively low compared with market expectations. Indeed, the long end of the yield curve is falling steeply despite current high inflationary trends, reflecting investor demand and expectation of long-term stable inflation. National savings certificates are the most popular savings vehicle, sold through 9,000 post office branches and 3,300 commercial bank branches. The savings scheme suppresses potential demand for market-traded instruments, as they offer market rates, yet benefit from an implied sovereign guarantee. As a result, the targeted savings segment of small investors (those with deposits of up to Tk 50,000) account for only 20 percent of the funds mobilized (Balalle 2006). The FSAP 2009 underlines as problematic the absence of adequate investment instruments, and the practice of channeling insurance and NSS investment towards government needs, reversing term transformation. The stock of National Savings Directorate (NSD) debt outstanding stands at 8.9 percent of GDP at the end of FY10. The effective interest rate, at 9.4 percent in FY10, is higher than the market, causing a large increase in net sales of NSD certificated in FY10. The rates were cut by 1.5 percentage points to 2.0 percentage points as of July 1, 2010, to align them better with the market.

**Table 1 Bangladesh Stock Exchange: Key Indicators (2007- 2011)**

| | 2011 (April) | 2010 | 2009 | 2008 | 2007 |
|---|---|---|---|---|---|
| DSE Share Index | 6112 | 8277 | 4536 | 2630 | 3017 |
| Market Capitalization (Tk, bn) | 2,668 | 3,471 | 1,887 | 1,059 | 754 |
| Market Cap/GDP (%) | 37% | 47% | 32% | 7% | 5% |
| Number of Listed Companies | 230 | 218 | 236 | 277 | 266 |
| New Listings | 11 | 8 | 10 | 2 | 11 |
| Delisting | 0 | 1 | 28 | 43 | 0 |
| Turnover (Tk, bn) | 210 | 4009.9 | 1475 | 668 | 322 |
| Turnover Ratio | 95 | 115.5 | 78 | 63 | 42.7 |

*Source: Capital market Websites*

**The Bangladesh equity market increased sharply in capitalization and turnover in 2007-2011, without commensurate improvement in regulatory capacity and legal framework to safeguard stability (Table 1).** At the end of April 2011, Dhaka Stock Exchange (DSE) had a capitalization of $36.63 billion,[10] or around 37 percent of GDP. Of the total market capitalization, listed equity stocks valued $29 billion for 230 listed companies and 33 mutual funds. Trading takes place in the two exchanges, Dhaka and Chittagong. Annex A reports figures for the Dhaka exchange. The turnover was 6 times higher. The Dhaka Stock Exchange General

[10] The figure was $7 billion for 2009, and $47 billion for 2010, due to the market volatility.

Index rose from 1667 in 2005 to an all-time peak of 8,918.51 in 2010. Financial sector stocks dominate the market at about 47 percent of the market capitalization; manufacturing stocks are 28 percent, and services sector stocks, including power and real estate stocks, are 25 percent. Bank stocks are the most actively traded stocks, accounting for 32 percent of turnover in 2008, demonstrating the growing role of bank investment in the equity market and raising issues for financial system stability. Non-bank institutional investors play a limited role in the market and foreign investors are almost absent. In April 2011, 486 securities were listed on the DSE and 233 securities were listed on the CSE. On the DSE, Banks and Insurance represent about 25 percent of the market. Owners include sponsors[11] (43 percent), institutional investors (10 percent), government (8 percent), foreign investors (1 percent), and the public at large (38 percent). Ownership is concentrated. Overall, free float represents 42 percent of listed shares. The requirements for listing on the DSE are a minimum paid-up capital of 20 million Taka and at least 400 shareholders.[12] The SEC has classified companies regarding how they declare their dividends.[13] "A companies" regularly hold annual shareholder meetings and have paid dividends of at least 10% in the prior year, whereas "B Companies" paid dividends of less than 10 percent. Companies which neither hold annual meetings nor declare dividends are called "Z companies", and the SEC has the power to reconstitute their board. In 2011, 150 companies are in the A category, 21 in the B category and 97 in the Z category. Greenfield companies are placed in the G category (1 company), and all the other new companies are in the N category (14 companies).

[11] Sponsors are mainly from the founder's family. They often limit the executive management positions to the family members.
[12] The conditions for listing on the CSE are a minimum paid-up capital of 10 million Taka and at least 250 shareholders.
[13] Notification Settlement of Stock Exchange Transaction Regulations, 1998 DSE-343/97/910 §4,5.

## Capital Markets Regulation

**The regulatory framework of securities markets is dated and can be contradictory.** Bangladesh is a common law country, and its basic corporate legislation is the Companies Act based on 1913 UK legislation, and is not always clear in the current Bangladeshi context. Securities regulation takes precedent over the Companies Act (for issuers), and little attempt has been made to harmonize the two. Specifically, there are a number of differences, and some contradictions, between banking law, banking regulation, the Companies Act, SEC regulation, and listing rules. Thus differences in application emerge, depending on the relevant regulator. The parts of the Companies Act that are not reinforced by the SEC or BB regulation, and are left to the Registrar or courts, are not enforced consistently, or in some cases at all.[14] The courts are slow, and lack expertise in corporate and financial matters, and the Registrar is not an effective means of redress, as its capacity is weak. Registrar filings remain in paper form.

**The capital markets regulators remain poorly equipped and insufficiently coordinated to supervise a rapidly growing market and growing number of brokerages and merchant banks.** The government debt securities primary market is regulated by the MOF and BB, and the OTC secondary market is under BB. All exchange-traded securities, including government debt, are under the SEC, including equities, corporate bonds, and the debenture market. Insurance companies are regulated by the Office of the Chief Controller of Insurance.[15] Concerns have increased due to the advent of margin lending and the entry of several banks into direct stock purchases. The entry of banks into merchant banking and brokerage business has created competition with the traditional brokerages. In addition, there arise the common issues of a mutualized market of conflict of interest between the owners/brokers and the investors. BB and the SEC have a signed Memorandum of Understanding for cooperation, which may need to be further operationalized. There is even more overlap with other regulatory entities, including the stock exchanges and the central depository, and coordination is not strong enough there either. Joint meetings to share information are supposed to be held every 2-3 months between the SEC, BB, the Registrar, and the Comptroller of Insurance, but more work is needed on coordination.

***The Bangladesh Bank (BB),*** the central bank of Bangladesh, was created in 1972 under the Bangladesh Bank Order. The nine board members are appointed by the government. BB has legal authority to supervise and regulate commercial banks and banking institutions. It can impose penalties for non compliance. BB also articulates monetary policy and prudential regulations such as ensuring minimum capital requirements, applying limits on loan concentration and insider borrowing, and providing guidelines for asset classification and income recognition. BB regulates the non-bank financial institutions under the Financial Institutions Act, 1993 and the microfinance institutions are regulated under the Microcredit Regulatory Act, 2006. BB oversees payments, cash, noncash, and foreign currency settlement systems.

[14] The Registrar is overseen by the Ministry of Commerce, rarely uses its enforcement powers, and is poorly resourced. Courts enforcement of securities markets issues is poor.

[15] The Chief Controller of Insurance operates under the Ministry of Commerce, as well as under the Insurance Act 1938; insurance rules issued in 1958; the Insurance Corporation (Amendment) Act 1990; and key investment policy guidelines issued by the Ministry of Commerce in October 2004 to clarify asset exposures for insurance firms. The regulatory structure for the insurance industry remains underdeveloped and not yet geared toward playing its role in the industry's development.

***The Securities and Exchange Commission (SEC)*** regulates institutions engaged in capital market activities, including the stock exchanges, issuers, brokers, merchant bankers and other intermediaries such as trustees and underwriters, and investment funds. It exercises its powers under the Securities and Exchange Ordinance 1969 and the Securities and Exchange Commission Act 1993. It is attached to the Ministry of Finance. The chairman and the members of the SEC are appointed by the government. The SEC issues and retracts licenses, approves new securities issues, conducts investigations, produces binding regulation, and can fine both issuers and their directors. The SEC further oversees securities settlement systems. The SEC conducts dozens of investigations involving issuers each year. Most SEC enforcement involves administrative actions or penalties, and there are over 300 court cases pending (see Annex B).
Over the last several years Bangladesh's capital markets went through a number of improvements including automation of the trading system, mechanization/dematerialization of paper stocks, and the introduction of a central depository. Despite such achievements, the SEC has not reformed its functions, staffing and oversight capacity since its creation in 1993. Its budget, salaries, and personnel decisions remain inflexible. The SEC has also failed to attract and retain highly qualified professionals capable of keeping up with increasing market complexity. It also requires an overhaul of its IT platforms. Finally, the SEC must develop its governance structure and introduce strict and enforceable rules against malfeasance.

***The Central Depository Bangladesh (CDBL)*** maintains a central depository system of electronic book entry under the Depositories Act, 1999, recording and maintaining securities accounts and registering transfer of securities; changing the ownership without any physical movement or endorsement of certificates and execution of transfer instruments, providing a platform for secondary market trading of government debt. CDBL is owned by more than 80 institutions including nationalized, private, and foreign banks, insurance companies, DSE, CSE, listed companies, the Investment Corporation of Bangladesh, and the Asian Development Bank. 235 companies have registered their shares with the CDBL.[16]

***Stock exchanges.*** The Dhaka Stock Exchange (DSE) and the Chittagong Stock Exchange (CSE) are self-regulated private sector entities which must have their operating rules approved by the SEC.[17] The stock exchange powers include approving new issues, overseeing compliance with listing requirements, and monitoring their member brokers for misconduct. Each exchange also has a Surveillance Department that engages in ongoing, real-time surveillance of trading. Each stock exchange operates its own clearinghouse for the settlement of securities transactions.

***Accountancy bodies.*** The Institute of Chartered Accountants of Bangladesh (ICAB) regulates the accountancy profession and oversees professional ethics and code of conduct by its members, provides specialized training and professional expertise, and fosters acceptance of International Accounting Standards (IAS) and International Standards on Auditing (ISA) by adopting the same as Bangladesh Accounting Standards (BAS) and Bangladesh Standards for Auditing (BSA) respectively. The Institute of Cost and Management Accountants of Bangladesh (ICMAB) is an autonomous professional body under the Ministry of Commerce. ICMAB offers Cost and Management Accounting education and research. It also regulates and promotes the profession of cost and management accounting in the country.

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[16] Full delivery versus payment is not yet in place. Settlement is T+3 for "A" listed companies, and T+7 for "Z" listed companies.
[17] The legal framework for those stock exchanges is provided by the Securities and Exchange Ordinance, 1969 and the notifications made under this ordinance, the Securities and Exchange Commission Act, 1993 and the rules made under this Act, the listing rules of the Dhaka Stock Exchange,1999 and the rules of the Chittagong Stock Exchange.

## Transparency and governance in capital markets

**Market stability is threatened by poor transparency**. Disclosure by companies is limited by the small size of the accounting profession and little oversight of the quality of financial reporting. The SEC is mandated to verify financial statements submitted by the listed companies; but it does not have specialized chartered accountant staff who could perform these functions. Many companies, especially those in the "Z" tier, do not make required filings, and their value is not in line with fundamentals. Market participants in general are skeptical of the information provided by issuers. Recent reforms, including the introduction of a Credit Information Bureau and mandatory credit rating for issuers and financial companies, do provide some stakeholders with additional sources of information. Critically, insiders are seen to benefit disproportionately from the control of companies and banks. The SEC has become more vigilant over time, but there have been no convictions for insider trading or market manipulation as of the time of this assessment.

***Corporate Governance.*** The SEC issued Guidelines on Corporate Governance in 2006.[18] Listed companies are required to "comply or explain". The Guidelines cover some key topics, including the functioning of the board, and internal and external controls. The Guidelines do not deal with other aspects of corporate governance, including shareholder rights. Compliance is at its early stage - in 2007, about 33 percent of the companies declared full compliance with the Guidelines and 60 percent declared partial compliance. BB issued Prudential Regulations on Corporate Governance for Banks in 2003. The Capital Markets Institute provides director training. The Bangladesh Enterprise Institute (BEI), a research center established in 2000, organizes governance training, and has issued a more detailed Code of Corporate Governance in 2004, which is poorly observed.

**The 2010-2011 crash was caused by clever exploitation of existing regulatory weaknesses which would be addressed. However, further loopholes remain which also need attention.** As a first step, insider trading rules would need to be strengthened. While insider trading is forbidden in Bangladesh,[19] the listing rules and other securities regulation have inconsistent definitions of insider trading. As is the case in many countries, there have been no prosecutions for insider trading. A second potentially harmful loophole is provided by lax rules on related party transactions that company insiders could use to extract value from the company. RPTs do not have to be disclosed before they take place, and do not have to be approved by shareholders. Third, weak rules on different classes of shares may permit a small number of privileged shares to expropriate company value from dispersed shareholders. Specifically, the rights attached to any class of shares can be changed by a resolution in a separate meeting of the owners of those shares but also with the consent of any proportion of those owners fixed by the memorandum or articles.

**The disclosure and transparency regime of listed companies is poor.** Specifically, financial statements and other basic documents are rarely available at the Registrar's, SEC, or company headquarters, and Z-listed companies as a rule have no annual figures.[20] In addition, there is no

[18] SEC/CMRRCD/2006-158/Admin/02-08.

[19] Penalties can include 5 years of imprisonment or/and a fine of 500,000 Taka ($7,280).

[20] In preparing the World Bank (2008) Corporate Governance ROSC report, the annual reports of only 53 companies were

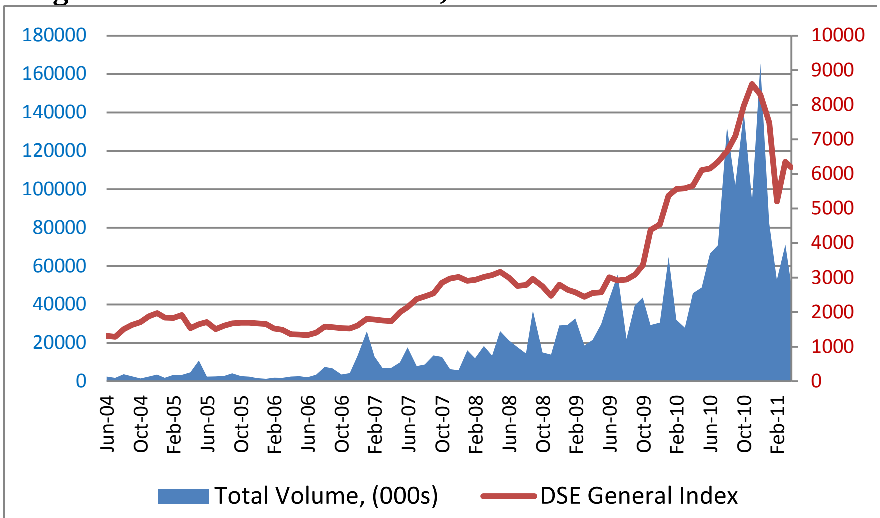
website where investors can easily review financial or other company data for listed companies. That precludes investors from obtaining a clear picture of company ownership, share class information, and other essential details. Corporate ownership is disclosed at the 10% level, but only direct shareholdings are reported. Indirect (sometimes called "beneficial") ownership is not required to be disclosed. In practice, custodian accounts and holdings through related parties are both used to conceal control. International standards of accounting and auditing are being introduced, but are not fully implemented, with a resulting weak application of accounting integrity. For example, many companies do not prepare consolidated accounts. There is no formal process for audit review in Bangladesh, and many market participants are skeptical of audit quality.

**Listed company oversight provisions are also weak.** Director responsibilities are not well defined. The number of board positions one person can hold is not limited and does not have to be disclosed. The Companies Act and other regulations provide limited guidance on board member responsibilities. Further, the law is unclear on whether the board can oversee the selection and replacement of key executives. Less than 30% of listed companies have an audit committee to review internal and external controls, and less than 20 percent of the companies have had an independent director sitting in the committee. The director nomination process is neither formal nor transparent to shareholders. Director training is available, but not widely used.

available at the SEC library.

## Causes of the Stock market Volatility

**Figure 1 DSE Performance, 2004-2011**




**The Bangladesh stock market capitalization in December 2010 surged to over three times that of 2008.** Stock prices rose 80% over 2009-10 (Figures 1, A1, A2); the DSE General Index peaked at 8,918.51 on December 5, 2010 and has since gone down over 40%, reaching 5,203 on February 28, 2011. However, the market has recovered some of the lost ground over the last 3 months as the benchmark index stood at 5,763 on June 5, 2011. On December 19$^{th}$ stocks fell nearly 8% (712 points from its peak), the worst one-day fall for 55 years. On the same day, the money market overheated and the inter-bank call money rate reached 180 percent, as banks raised call rates to cash in on the liquidity crunch in the market. Bangladesh Bank intervened to fix the inter-bank call money interest rate at 50 percent. In response to the speculative bubble, Bangladesh Bank reported having taken adequate measures to safeguard the banking sector, whose exposure is reported at 3% currently. A large dose of the reasons for the capital market volatility is attributed to regulatory instability, as well as the low capacity of the Securities and Exchange Commission (SEC) and their lack of a strong enforcement framework.

**The stock market surge was fueled by the spare liquidity from the banking system, as remittances chased after too few stocks in search of better returns.** The 2007-2008 years of transitional government saw a general lowering of domestic investor confidence in the real sector, sending excess capital abroad as well as into relatively non-transparent stock markets. During 2008-2009, as the global financial crisis raged, remittances surged and real sector investment decreased further, infusing the banking sector with excess liquidity that ultimately found its way into stock markets (Figure 2). A considerable demand-supply gap was formed as new demand dwarfed the few new issues coming in the market. As the stock market grew without a commensurate improvement in the institutional and regulatory framework, uncertainty increased as well, as illustrated in higher trading volatility (Figure 3). Average daily trading volume increased eight-fold between June 2006 and June 2007, and doubled every subsequent year, peaking in December 2010 at 77 times its June 2006 volume. Central bank regulations in early 2009 introduced a lending cap lowering deposit rates and further pushing liquidity from bank deposit accounts to capital markets. Banks and non-banking financial institutions alike increased their equity positions throughout 2009.

**Figure 2 DSE Market Value, 2004-2011**

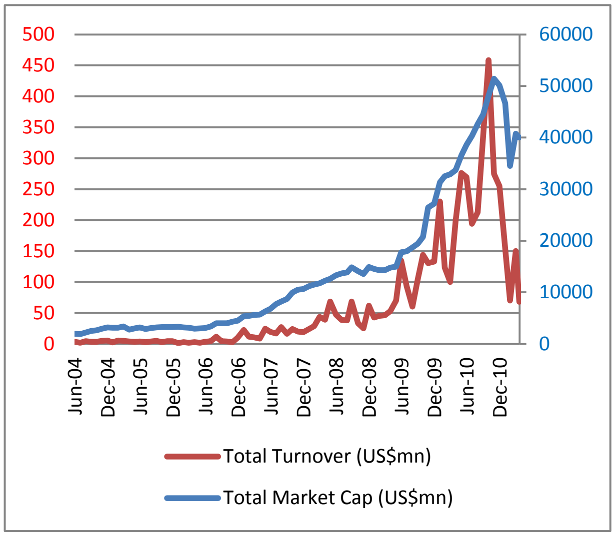
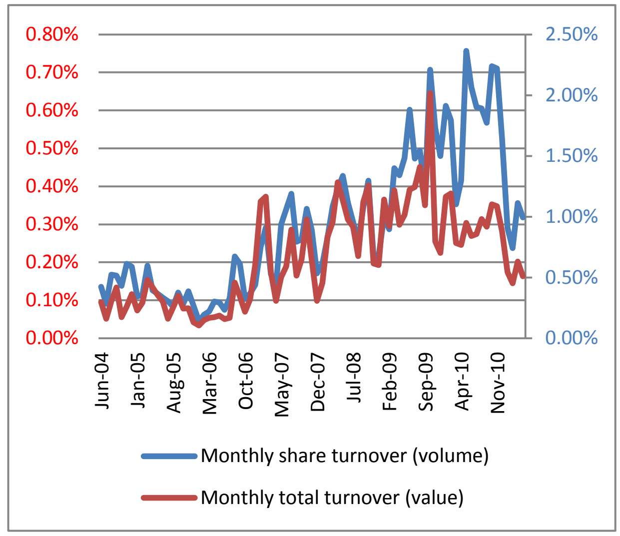



**Figure 3 DSE Volatility, 2004-2011**




**SEC regulations contributed to the market's surge above fundamentals and a drastic increase in the investor base. Stock exchanges in turn did not address listed company weaknesses, nor delist defunct companies.** As the market was attracting liquidity, insiders contrived to use market information to manipulate pricing, using several mechanisms. First, the SEC rules on use of "direct listing" and "book-building" method for valuation of initial public offers were inconsistent, allowing overpricing of IPOs and causing a sharp departure of stock from fundamental value based on poor application of accounting principles.[21] The SEC did not sufficiently scrutinize the manipulations associated with audited financial statements, determination of base price, defining comparable stocks, and use of an appropriate multiplier in IPO pricing. Second, listed companies en masse revalued their assets in 2009 and 2010, to mark to market their real-estate holdings, an incidence that exceeded similar activities over the previous two decades taken together, and resulted in sky-rocketing net asset value of the stock. Third, weak accounting and audit standards added a measure of further inconsistency, as listed companies submitted unreliable financial statements or based their valuations on unaudited quarterly financials. Fourth, the over-valuation was fuelled by stock splits, with the SEC's permission. Fifth, as oversubscribed company stocks were floated in private placements, and share values boosted artificially by the influential investors who bought the privately placed shares, insider stock-holdings surged. The SEC's decisions on rules regarding price, quantity, and sale of the placement shares added to the confusion, and inadequate investigations were launched on possible irregularities signaled in the media. These five market manipulative techniques, as well as others, pushed stock prices up artificially, as the general index jumped from 2,931 in September 2009 to over 4,500 at the end of December that year, and average daily trading more than doubled to over $86 million. Trading against experienced insiders

[21] Valuation of IPOs is already difficult in emerging markets such as Bangladesh due to the lack of proper comparables, as the number of stocks in the capital market is small. Valuation in Bangladesh was further challenged due to the presence on non-recurring items in some companies' income statements which distorted earnings multiples relative to the companies whose figures are used as comparables. Further, some IPO company book values were enhanced by revaluation surpluses (such as from re-valuing real estate which surged in price recently), especially if comparable companies have not revalued at the same time. Using over-valued comparables (many IPOs were issued at a time of general surge in stock prices) further inflates deviation from fair values, especially if market intermediaries are not careful to link multiples also to operating metrics.

manipulating prices was the financially less savvy general public, which rode the bullish sentiment and bought heavily into the overheating market. Around 600 new branches of brokerage houses were opened in 32 districts, with SEC's blessing, drastically enlarging the investor base, as 1.3 million new beneficiary owner's accounts were opened as compared to about 0.5 million accounts in existence in 2006. A final distortion was introduced by lack of transparency of the identity of beneficiary share trades, helping insiders rake up profits – merchant banks carried out transactions of thousands of individual investors using one omnibus beneficial owner account, making it difficult for the regulators to detect insider/related party transactions.

**During the following year the governance of the stock market worsened further**, as the SEC issued a total of 81 directives on changes in margin loan rules, use of net asset value, private placements, and PE ratio of the listed stocks, rules on issue management, and use of insider information. The margin ratios were as high as 1:2 in January 2011. The regulatory instability had the effect of leveraging investors' funds, further enhancing equity values in an artificial and unsustainable manner. This had the effect of pushing the general index to 8919 on December 5, 2010 from a value near 4500 at the end of 2009, or a 97% annual rise, while average daily trading volume reached over $233 million, a 172% rise in a year. Noting the clear symptoms of a bubble, BB increased cash reserve ratios by 50 bps to 6% in early December and postulated a limit of 10% of liabilities for bank exposure to the capital markets, in a bid to safeguard banking system stability. This regulatory policy led to banks liquidating a vast part of their shareholdings en masse, directly causing an unprecedented drop in stock prices on December 19th, 2010. This also prompted a disorderly scramble for cash, sending the call money rate to a historic high of 190%. The bubble burst, and by February 2011 the general index had dropped to 5,203.

**There are several channels through which a stock market crash could impact the real economy.** There are two effects that pull down equity prices in a stock market crash. The beta effect is caused by the fact that most stock prices move together, so good stocks will fall, pulled by the general market. Second, companies whose worth depends on capital markets earnings (such as banks) will see their equity prices fall as well, pulling the overall market further down. The two effects will feed off each-other. A third effect is the market overshooting effect, whereby investors are found to be both excessively optimistic in a surge and excessively pessimistic in a crash, as the market value tends to drop below fundamental fair value initially, only to recover upwards subsequently. The Bangladeshi market has lost almost half of its peak levels. A significant channel of bubble transmission is the financial sector, with banks channeling excess liquidity into equities in proprietary trading and margin lending. Banks lent considerable amounts to leverage private stock market investors. Depending on the extent of stock price falls, there is a risk of investor default, which in turn could weaken bank balance sheets. To the extent that banks liquidated some of their stock market positions at considerable profit, it is conceivable that profit-taking will cover for any losses incurred through investor defaults.

**The banking sector's exposure to capital markets is still unclear.** According to a study by BB in 2010, 18 financial institutions had invested more than 25% of total liabilities in the stock market; eight of those had invested more than 50%. The banking sector exposure to those is a declared 3%, resulting in potential NPL increase from the current 4.5% to 7.5%. Most banks' exposure to the equity markets is via subsidiary merchant banks. Banks are still in the process of complying with the 10% limit of stock market exposure and are more vulnerable to market panic as a result. Noting the equity/asset ratios of Bangladesh banks (8.28% for a sample of 22 private commercial banks using 3Q2010 numbers), even a 5% exposure to equities equates with 55% of these banks' equity. For a number of banks, the capital market exposure is closer to 10%, or greater than their equity base. This poses a significant risk through the bank's proprietary portfolio performance.[22] To this, one should add the risk of losses from margin lending (as noted above, those should be largely covered by 2010 bank profits), as well as any losses from diverted loans, or loans declared for business or personal use, but actually diverted into the stock market. There are no reliable estimates of this latter exposure for banks, but there is circumstantial evidence that it could be substantial. Moreover, the use of credit cards to fund stock purchases increased during this period. A massive increase in the number of credit card issuances was observed in 2010, and this could push credit card defaults. Estimates of the overall effect of diverted loans could be an additional 4%-7% of the banking sector assets. If correct, this could increase NPLs up to 15% potentially.

**The rapid increase in nontraditional banking activities in recent years has generated new market risks in the financial sector.** Bank investments in the stock market, and specifically state-owned banks under encouragement to prop up equities, weaken the financial system. Those risks get added to the significant and long-standing risks and vulnerabilities with respect to uneven loan classification, provisioning, and capital, as well as non-prudential government intervention. In addition, these factors reduce transparency and create inefficiencies, adding to the problem of inadequate information, attributable to non-transparent accounting and reporting, which affects market discipline. The current asset quality of commercial loan portfolios is weak, with a large share of loans classified in the substantial, doubtful, and loss categories. The recent unrealized bank losses from the stock market plunge have eroded banks' profits thereby reducing their capital. There is liquidity stress in the system, as evidenced by rising deposit interest rates at some banks and volatile interbank interest rates. Turnover at the interbank foreign exchange market is falling, suggesting further pressure on the Taka, as investors and treasurers seek more attractive rates elsewhere. Credit growth has been excessively high in recent years, suggesting elevated NPL ratios may be expected. Yet BB has pursued a relatively accommodative monetary policy stance, and it is reluctant to raise further its repo rate as conditions in the interbank and foreign exchange markets are volatile. Despite major improvements resulting from BB's state-bank restructuring program state banks remain financially weak. Three state-owned commercial banks pose a stability risk due to their size, limited capital and high NPLs. Due to their size these banks distort sector-wide measures of asset performance and capital adequacy. Other risks for the real economy include a possible drop in real estate prices which could severely impact banks – about 20% of loans are to the real estate sector, and over 60% of total loans and advances are secured with land and/or buildings. Although BB is tightening prudential standards, this has not yet resulted in lower exposures. Finally, there is a risk of inflation (if further liquidity is pumped in the system), feeding into food prices, as well as possible political consequences from market volatility.

**The proposed Bangladesh Fund could pose a risk to banking sector stability due to the stock market's volatility.** The MOF vehicle proposed as a short-term measure to address the

[22] There is also a circularity issue since there is cross holding of stocks within the financial sector's portfolio investments.

issue of financial sector volatility effects is a Tk$50bn ($427mn) mutual fund backed up by a large number of mostly state-owned financial institutions. The aim of the Bangladesh Fund would be to prop up the stock market in the current high volatility period, by buying good stock that are not over-valued, and thus steering investors away from highly-overvalued and junk stock, while guiding the market to realign with fundamentals in a soft landing. This might be difficult to achieve in practice. This is taking into account that about 40% of listed companies are "Z" companies, and a considerable number of listed companies are over-valued to a moderate-to-high degree per comparable ratio analysis. The planned fund would put its equity funders at a high risk if estimates of the stock market valuation are correct.

## Priority Action Steps and Possible Way Forward

The following eleven action steps are suggested to address the immediate aftermath of the stock market volatility, as well as medium- and long-term priorities in capital markets development.

| SHORT-TERM ACTIONS | |
|---|---|
| **1. Ring-fencing banks from capital markets instability and solidifying regulatory cooperation and coordination** | Focus should be on (1) BB enforcement capacity, (2) joint bank supervision of BB with SEC, (3) curbed margin lending, (4) reduced equity exposure for banks, (5) State-owned bank corporate governance; (6) contingency plans, and (7) Chinese walls between banks and merchant banks.<br><br>Reducing the risks to the financial system will depend on stricter regulation and supervision and greater cooperation between regulators, to eliminate the opportunities for regulatory arbitrage. Overlap in the authority of SEC, Registrar, BB, Comptroller of Insurance, and the two exchanges should be examined and clarified. Regular joint meetings should be reinforced to effectively share information between the SEC, BB, the Registrar, the Comptroller of Insurance, and the MOF. |
| **2. Strengthening SEC governance, resources, and enforcement** | SEC strengthening is needed through (1) greater autonomy in budget, (2) personnel and (3) better rules enforcement. The SEC advisory board needs to be activated or it should be replaced by another active body, meeting regularly for making policy recommendations. |
| **3. Tightening stock market rules** | Specific focus should be placed on rules for (1) IPOs, (2) placement of shares, (3) beneficial owner accounts, (4) regulatory staff trading, (5) asset revaluation, (6) price discovery, (7) rights shares and convertible preference shares, (8) merchant banks licensing, and (9) Z-companies. Rules should be strengthened on (1) insider trading, (2) related party transactions, and (3) board oversight, including director fiduciary duties, director selection, disclosure, and board independence. Transparency improvements include (1) the accounting and audit quality, (2) corporate disclosure, especially of beneficial owners, (3) investor literacy and director education, and (4) a stronger role for institutional investors. |
| | |
| MEDIUM-TERM ACTIONS | |
| **1. Strengthening stock market regulation and governance** | A review of (1) the legal framework and (2) corporate governance aspects. The governance of the Dhaka and Chittagong Stock Exchanges needs further strengthening, as does that of the payment system and CDBL. Demutualization of the exchanges should be strongly considered, in an incentive-compatible approach to reform. |
| **2. Developing the government debt market** | Develop market infrastructure, including (1) upgrading the depository, clearing, and settlement arrangements; (2) promoting development of the money market; (3) strengthening the government's cash and debt management capacity; and (4) enhancing efficiency and transparency of secondary markets.<br>Further steps include (1) creating an enabling legal and regulatory framework, (2) reducing market distortions from the National Saving Certificates, and (3) augmenting the investor base, particularly through institutional investors. |
| **3. A vibrant corporate bond market** | Actions include: (1) further reducing bond issuing costs, (2) strengthening the credit rating industry, and (3) strengthening SEC enforcement to build investor confidence. An alternative, longer-term goal could be (4) the creation of an enabling environment for asset-backed securitization. On the demand side, long-term investors need to be developed, such as pension funds and insurance companies. |

## Detailed Priority Action Steps

**SHORT-TERM Action Step 1. Ring-fencing banks from capital markets instability and solidifying regulatory cooperation**

BB and the SEC should ensure the stability of the banking sector by strengthening governance and providing a stable regulatory environment. Specifically, in the short and medium term, steps are needed to limit the effects of volatility on the financial sector and the real economy. Bangladesh Bank should work to curb existing bank exposure to the stock market, and beef up provisions for NPLs expected to increase due to diverted loans. Specifically, focus should be on:

- **BB enforcement a**nd oversight capacities could be enhanced, and a reexamination of capital rules and other prudential requirements, such as risk management standards, would be beneficial to ensure risks are fully addressed.
- **Consolidated supervision** on banks' subsidiaries could be conducted by performing joint on-side examinations with SEC. Supervisory authorities should enhance their enforcement and oversight capacities and re-examine capital rules and other prudential requirements, such as risk management standards, to ensure that risks are fully addressed.
- **The margin lending ratio** could be reduced further (for example to 1:0.5), and maintained at that reduced level for a sustained period of time.
- **Bank exposure to equities**. Stress tests suggest that banks are vulnerable to equity price risk and need to reduce their stock market exposure and strengthen their capital buffers. Risks are particularly pronounced for state-owned banks. To reduce the banking system's vulnerability to equity price risk, the total exposure to the stock market (both direct equity holdings and indirect exposures through lending) could be set more conservatively (e.g. at 25% of capital). The transition to the new limit should be phased in gradually over an extended period of time to prevent destabilization of the stock market. Investments made by the commercial banks in the capital market should be considered as part of their Tier 1 capital; for this section 26(2) of the Banking Companies Act should be amended in line with the BASEL principles of capital adequacy.
- **State-owned bank corporate governance** needs to be further strengthened. Specific actions may include (1) the inclusion of financial experts on boards of directors, (2) capacity building of the government institutions that act as owners, (3) improved financial reporting and internal controls, (4) clear mandates and targets, and (5) performance monitoring.
- **Contingency plans** for supervisory actions should be developed. These need to include: (i) an emergency liquidity facility and (ii) a Prompt Corrective Action regime to provide a regulatory framework for taking action against banks that exhibit signs of deteriorating financial viability.
- **Better Chinese walls** could be introduced between banks and merchant banks.
- **Cooperation between BB and SEC** regulators should be improved to follow the potential risks between commercial and merchant banks in the event of market volatility. Better integration and coordination of monetary policy and capital market development policy would help. Specifically, a council of regulatory agencies could be established, including the BB, MOF, and SEC, with a mandate for financial stability and powers inter alia to designate potentially systemic financial firms for enhanced regulation and supervision focused on systemic risk. BB could be defined as a lead executor of this council and the consolidated supervisor of designated potentially systemic financial firms, to work with other regulators. Further, BB could exercise oversight authority over systemically important payment,

clearing, and settlement institutions. At a minimum, BB should resume its effective seat at the board (or advisory board) of SEC, to ensure frequent and functional coordination between the two authorities. A memorandum of understanding could be considered as well.

- **MOF and BB**. A functional coordination platform is needed between the new debt management wing of MOF and BB.
- **SEC and stock exchanges**. A study team should be formed to identify the areas of overlap between the SEC and the stock exchanges. Day to day surveillance can be done by the stock exchanges and for this the surveillance department of the exchanges should be strengthened. The surveillance division of the SEC can be reconstructed into 'inspection division' and a system of inspection should be introduced to cover the activities of all agencies in the market.

### SHORT-TERM Action Step 2. Strengthening SEC governance, resources, and enforcement

SEC governance, resources, and enforcement require strengthening. Recent SEC regulations should be reviewed and streamlined, enhancing their consistency.

- **The lack of SEC autonomy** prevents the rapid pace of reform, so that SEC might keep up with the pace of market growth. The present structure of the SEC has failed to attract and retain professionals with strong capability to monitor and enforce the regulations in place. The growth of the market and its increasing complexity requires more regulators with market experience. Greater budgetary autonomy should be considered for the SEC.
- **SEC Remuneration** at the SEC should be comparable to BB, and management should be given more flexibility in responding to staffing needs. Going ahead, market rates should increasingly be the reference point for SEC professionals, so that the talented professionals are attracted to join the capital market regulator and staff turnover is not excessive. Capacity building is required, to bring in international best practice and ensure training on products and capital markets development.
- **SEC Enforcement.** The SEC must develop governance and strict, enforceable rules against malfeasance. In response to the recent stock market instability, the government has removed top SEC leadership, and effectuated related reforms. However, more is needed – SEC leadership appointment process should be institutionalized, and SEC members should be held to the highest technical qualifications in the fields of law, accounting, banking. The SEC requires a strong inspection department, a listed companies accounting statement analysis department, and requisite investment in software and systems to allow adequate market monitoring of compliance, and beef up enforcement. Checks and balances need to be ensured for SEC's independence from the influence of market participants and the government.

### SHORT-TERM Action Step 3. Tightening stock market rules

Higher standards of corporate governance should be established in the capital markets, to stimulate investor confidence and superficially the participation of small investors. These standards would need enhanced enforcement by the SEC and the stock exchanges. Finally, securities markets would operate more efficiently, and become deeper and broader, with improved investor confidence through enhanced transparency, better auditing quality, corporate disclosure, all-around capacity building, and a larger role for institutional investors.

- **Price manipulation rules:** Given the regulatory instability in the recent years, it is further necessary to review the SEC rules and ensure a more systematic, stable and consistent approach, with more transparency and detailed guidelines and checklists for all regulated entities. The following rules should be reviewed:

- Rules on IPOs should improve transparency and compliance monitoring.
- The usefulness of placement shares should be reconsidered. At the least, the allotment letter should be copied to the SEC and the 'curb market' for placement shares should be stopped.
- Investment through omnibus accounts should not be allowed.[23]
- Executives and staff in regulatory agencies related to the capital markets, including BB, should experience insider trading-type restrictions on their stock market investments.
- Asset revaluation of listed companies should be monitored by SEC and must be performed by expert accounting firms until establishment of chartered surveyors' institute in the country.
- The price-discovery process should be re-examined to regulate the use of the book-building method, and a more market-based price should be used.[24]
- The rules on rights shares and convertible preference shares should be made more robust.
- The merchant banks licensing rules should be re-examined to eliminate conflicts of interest. Merchant banks should not perform as brokers. Market-maker rules should be strengthened.
- Consider resolving the long-standing problem of Z-list companies, and de-listing them.

- **Insider trading**. New acts or comprehensive regulations on insider trading should be introduced. The insider trading rules should use the common expression "insider trading" and the definition should be harmonized with the one in the stock exchange listing rules.
- **Related party transactions**. The possibility and nature of significant size transactions and strategic sells should be addressed in the SEC rules or elsewhere in the legislative framework. For better protection of investors, provisions on related party transactions should be significantly reinforced. The potential operations in which related parties are involved should be disclosed before they take place, together with the opinion of the audit committee on the operation. Shareholder approval should be required for all the transactions exceeding a certain threshold, for example 5 percent of the company's assets.
- **Board oversight**. The fiduciary duties of the board should be codified, reflected in the Corporate Governance Code, and made explicit. Directors should have explicit duties of loyalty and care to the shareholders and the company. The nomination process for directors should be specified. Minority shareholders should be able to nominate directors. The number of other board positions held at the same time by a director should be limited (for example to 5). Those positions should also be disclosed to the company and in the directors' report. The separation of the functions of the chairman and the CEO should be required. A requirement for board self-evaluation should be added to the Corporate Governance Guidelines. Over the long term, the number of independent members on the board should be increased, in line with international good practice (for example, at least one-third of the board of listed companies in India is required to be independent). Directors who do not disclose their conflicts of interest should be held liable for any damages (currently, they are only responsible for a small fine). Fit and proper provisions for directors should be in place, listing minimal criteria for eligibility, such as the requirement to be free from past litigations.
- **Audit quality**. A number of steps should be taken to raise audit quality for listed companies. Regular reviews of audits performed for listed companies should be introduced. This may be through peer review, by ICAB, by the regulators, or through another mechanism. The SEC could consider making its list of eligible auditors more stringent. Further, the SEC could

[23] The merchant banks can maintain shadow accounts for their accounting purposes.

[24] For example, by being obliged to buy at least 10% of the issuable shares at the weighted average price called by all the bidders, and by longer mandatory lock-in periods (for example 180 days).

enforce quality of information, in addition to its quantitative approach to both audit and corporate governance disclosures. Reasonable limits should be placed on auditors performing non-audit services for their clients. ICAB should continue its efforts to police misconduct by its members and adopt the IFAC Code of Ethics. The proposed Financial Reporting Commission should also be established, especially if ICAB does not make greater efforts to police its members. Other oversight mechanisms for ICAB might also be considered. Efforts to implement IFRS for listed companies and other public interest entities should be accelerated.

- **Corporate disclosure**. The obligation of major shareholders to disclose both direct and indirect control should be clarified and reinforced. The new law on takeovers should include rules for acting in concert to require disclosure by related or cooperating parties seeking to take control of a company. Disclosure should also be improved for: director and key executive remuneration (individually and in aggregate), material risks and risk management policy, human resource and other material issues related to stakeholders. More company information, especially the contents of annual reports, should be available to investors online. One website—either the SEC, Registrar, one or both of the exchanges, or a newly created website—should have extensive information for all listed companies.
- **The Institute of Capital Markets**, in cooperation with the SEC and the exchanges, should play a larger role in educating practitioners and capital market participants, investors, directors of listed companies, and executive directors of the SEC. It should also work to improve the knowledge base of capital markets related agencies.
- **The role of institutional investors** – mutual funds, merchant banks – should be strengthened in view of stability and insuring that uninformed investors get advised or outsource investment management to expert traders. The mutual funds' industry and expertise needs to be strengthened as well.

**<u>MEDIUM-TERM Action Step 1. Strengthening stock market regulation and governance</u>**

The first priority following the recent stock market instability in Bangladesh is to address the regulatory and institutional framework, in order to reassure investors. This involves:

- **A review of stock market laws**. Bangladesh has undertaken important reforms in the area of capital markets in recent years, but to tap their full potential will require that reform continues. A legislative revision and modernization of key laws is a necessity, and could be contemplated in the longer run, including the Companies Act, the Securities Act, and aspects of the banking regulations, with a specific view to eliminate inconsistencies.[25] Revisions to or replacement of other relevant securities markets regulations to increase the coherence of the legal framework should also be considered. For example, the process for loans to bank directors in the Bank Companies Act and the Prudential Regulations for Banks should be

[25] To better protect investors, the new Companies Act (CA) should lower the threshold for redress by shareholders from the current 10 percent to 5 percent or lower. SEC regulations and the new CA should make clear that all shareholders are entitled for payment of dividends at the same time. Redress should also be reinforced to avoid late payment of dividends. Companies should not be able to decide on which proportion of shareholders can authorize the variation of their rights. The CA should require an approval of at least ¾ of the voting rights of the class of the shares subject to the change. The new CA should include a specific right for shareholders to ask questions at the annual shareholder meeting. Moreover, shareholders should be able to change the agenda by submitting resolutions to the board before the meeting. Failure to give notification for major corporate events should be a reason to invalidate the decisions taken. The CA should mention all the information required for the annual shareholder meeting notice, including time, date, location, and agenda. In the annual meeting, shareholders should also approve directors' remuneration. In addition, electronic and postal votes should be allowed.

harmonized. As another example, the Banking Companies Act may need strengthening in the areas of the overall monitoring framework of BB, rules regarding on-side and off-site supervision, procedures of repo- and reverse-repo operations, TB auction mechanisms, interactions with primary dealers, and rules regarding government bond operations. Further, the de facto ultimate enforcement bodies in the financial sector – courts and judges – are not educated in capital markets matters, including district judges, high court, prosecutors.

- **The Corporate Governance Guidelines** should be updated, and enforced more stringently. Many provisions in the Guidelines are aspirational and less subject to objective interpretation (e.g. board functions and responsibilities) and are not appropriate as mandatory legal provisions. Specifically, the sections related to the board and key executive should be reinforced. New provisions related to shareholders' rights and duties, minority representation, and general meeting should be added.[26] The current classification system for listed companies (A, B…Z) may also be reviewed to tie classification more closely to compliance with the Guidelines, and perhaps lowering the dividend requirements (i.e. lowering the threshold or allowing it to be waived in some cases).
- **Stock Exchange Governance**. The role of independent directors (including the President) for both stock exchanges could be enhanced. The exchanges should be governed with a firm view to act in the public interest and that of investors. The possibilities for improving the markets through demutualization of equity markets should be considered, including a careful analysis of the process of demutualization and its structuring, which would determine whether the demutualization process is a success. Demutualization is likely to strengthen the intermediation process by improving the balance between the interests of issuers/investors and those of brokers, who are members/owners of the stock exchange. It may help promote efficient and professional management that attracts a broader group of market participants, leading to a positive impact on market capitalization. Finally, it is likely to help generate a greater degree of automation in transaction settlement and day to day management of the exchange leading to improved operational efficiency and transparency.
- **Payment system**. Improvement in the capital market will also benefit from the improvement in the payments system, both with regard to exchange transactions and payments in general. The delivery of the securities "leg" has improved with the functioning of the central depository, however, the payments "leg" continues to be settled manually. Further automation and reforms are needed to support the rapid growth in the securities market.

**<u>MEDIUM-TERM Action Step 2. Developing the government debt market</u>**

Strengthening the government debt market will increase liquidity and the supply of long-term debt instruments, create a reliable yield-curve, and facilitate a more effective monetary policy transmission mechanism. An active government debt market forms the basis of a corporate debt market, by accustoming investors to buying and trading bonds and providing an index to value corporate debt. An enabling regulatory framework and a level-playing field are a must as well.

- **DVP.** Securities transactions in Bangladesh still depend on a manual payment system, and clearing and settlement does not yet happen on a delivery-versus-payment basis. To enhance the transparency and integrity of the market, the clearing and settlement process needs to be improved by moving toward a real-time gross settlement system.

[26] The voluntary Code of Corporate Governance issued by the BEI can be used as a reference and starting point.

- **Money Market.** Developing a well-functioning money market is a necessary building block towards an efficient government bond market, to anchor the short end of the yield curve, support the development of the foreign exchange market, and facilitate monetary policy transmission. It provides the authorities with better signals of market expectations, allows banks (and their customers) to better manage their liquidity, and strengthens competition in financial intermediation. A well-developed money market also helps promote private issuance of short-term instruments (negotiable certificates of deposit, promissory notes, commercial paper) and thereby supports the development of the longer-term corporate bond market. Development of secondary market for 90 days T bills and short term instruments for call money markets can be a good first step in this regard.
- **Public Debt Management.** The government has taken steps to strengthen debt and cash management, but gaps remain, in particular there is a strong need for an effective medium-term debt strategy. The Ministry of Finance lacks the capacity to provide reliable cash flow projections, though its young and dynamic debt management team is now upgrading its skills and IT platforms to improve public debt management.
- **Transparency** in the secondary market for government debt securities remains limited. There is no central source of information on trading activity in the OTC market. While Bangladesh Bank receives reports on OTC trading from primary dealers, it does not publish the information. Publishing this information in a timely fashion would help improve transparency in the OTC market and facilitate price discovery. Primary dealer capacity and systems need strengthening, and bringing in more non-bank primary dealers would be beneficial.
- **Enabling legal framework.** For both government debt markets and corporate bond markets, it is of crucial importance to continue developing an enabling legal and regulatory framework, and emphasize efforts on its effective enforcement. Priority areas of focus include maintaining fair, efficient, and transparent markets; reducing systemic risk; and protecting investors. An appropriate set of rules and regulations—commensurate with the level of market development – should be developed to govern the organization of the primary and secondary markets in government debt securities. These rules should also address the roles of different types of market participants. In addition, regulatory reform should devote attention to clarifying procedures for dealing with the failure of a market intermediary and to strengthening disclosure requirements, transparency, and valuation rules. To promote the development of the corporate bond market, regulatory efforts could also focus on creating an enabling environment for infrastructure bonds, which offer a potential starting point for developing the corporate bond market.
- **National savings certificates**, with their implied sovereign guarantee, depress potential demand for market-traded instruments. Reforming the national savings scheme to create a level playing field between market-traded instruments and national savings certificates would help reduce the market distortions. Key initiatives include aligning national savings certificates returns with market expectations, dealing with interest rate differentials and rollovers of debt, and targeting small investors. Consideration could also be given to replacing the present scheme with market-oriented mechanisms for raising government funds. Though aimed at small investors and pensioners, the national savings scheme attracts larger investors as well, and small savers account for only 20 percent of the funds mobilized. Transforming the scheme into a modern retail program equipped with modern information technology could help develop a retail investor base.

- **A large and diversified investor base** helps ensure strong, stable demand for government securities. Efforts to promote such an investor base should focus on facilitating the development of institutional investors— especially through pension reform and measures to strengthen the insurance sector—and creating an environment conducive to investment in the bond market by both domestic and foreign institutional investors. Implementing an investor education program would be of the essence as well.

**MEDIUM-TERM Action Step 3. A vibrant corporate bond market**

Improvements on both the supply and the demand side for corporate bonds are needed. Cheaper state-owned term lending is currently attracting corporations away from external funding options such as corporate bonds. To make bonds more competitive, factors limiting the issuance of commercial paper should be addressed:

- **High transaction costs** have discouraged public bond issues by corporate issuers. Lowering the costs of bond issuance—including the registration fee, stamp duties, annual trustee fees, and ancillary charges—should be part of a long-term plan to develop the corporate bond market.
- **The credit rating** work is of poor quality, and the credit rating industry requires strengthening. The domestic credit rating agencies have gaps in their capabilities, and the Securities and Exchange Commission has not yet built up adequate expertise in oversight of the rating agencies.
- **Gradually establishing the confidence of investors** should be an important focus of efforts to develop the corporate bond market. Toward this end, greater efforts are needed to enforce contractual payment terms of debt issues by disciplining issuers that fail to comply with these terms. Enforcing compliance with the disclosure requirements for listings on the stock exchanges would also help build investor confidence. Streamlining guidelines on issuance of bonds and debentures is a priority.
- **The potential for asset-backed securities** in Bangladesh is present, and this might be a viable strategy for long-term corporate bond market development. An early priority would be to overcome the hurdles to securitization— the tax and incentive problems, regulatory barriers, and shortages of knowledge and skills. Experts from developed financial markets could help familiarize the diverse participants in securitization with its concept and practice. To increase the popularity of asset-backed securities and reduce the cost of issuing these instruments, other steps will also be needed, including introducing a legislative framework governing securitization and standardizing its regulatory and accounting treatment.

## Annex A Bangladesh Stock Markets at a Glance

## Main Board – Dhaka Stock Exchange at a glance

| Main Board as on February 2011 | | |
|---|---|---|
| Total Number of Listed Securities | | 476 |
| Total Number of Companies | | 229 |
| Total Number of Mutual Funds | | 33 |
| Total Number of Debentures | | 8 |
| Total Number of Treasury Bonds | | 203 |
| Total Number of Corporate Bonds | | 3 |
| | | |
| **Total number of Shares/Certificates:** | | **(No. in mn)** |
| Total Number of Shares & Mutual Fund Certificates of All Listed Securities* | | 15,673 |
| Total Number of Shares of All Listed Companies | | 13,268 |
| Total Number of Certificates of All Listed Mutual Funds | | 2,393 |
| | | **(No. in ' 000)** |
| Total Number of All Listed Debentures | | 409 |
| Total Number of All Listed Gov. T-Bonds | | 4,672 |
| Total Numberof All Listed Corporate Bonds | | 7,336 |
| | | |
| **Total Issued Capital of :** | **(Figure Tk.in mn)** | **(FigureUS$ in mn)** |
| All Listed Securities | 719,316 | 10,105.59 |
| All Companies Shares | 220,543 | 3,098 |
| All Mutual Funds | 23,183 | 326 |
| All Debentures | 140 | 2 |
| All Listed Govt. T-Bonds | 468,113 | 6,576 |
| All Listed Corporate Bonds | 7,336 | 103 |
| | | |
| **Total Market Capitalization of:** | **(Figure Tk.in mn)** | **(FigureUS$ in mn)** |
| All Listed Securities | 2,349,353 | 33,006 |
| All Listed Companies Shares | 1,843,471 | 25,899 |
| All Listed Mutual Funds | 30,477 | 428 |
| All Debentures | 576 | 8 |
| All Listed Govt. T-Bonds | 468,113 | 6,576 |
| All Listed Corporate Bonds | 6,716 | 94 |
| **Conversion Rate: BDT against USD** | 71.18 | |
| | | |
| *** Total No. of Shares/Share Capital / Market Capital includes Bonus /Right of shares.** | | |

**Annex B** **SEC enfoncement actions, Sep 2009- Sep 2010**

| | Listed companies | Brokers / dealers | Others | Court Cases |
|---|---|---|---|---|
| Jul-Sep 2010 | 9 penalties<br>4 warnings | 3 penalties | 2 penalties | 332, of which 122 in the Supreme Court |
| April-June 2010 | 23 penalties<br>14 warnings | 1 penalty<br>11 warnings | 3 penalties | 293, of which 113 in the Supreme Court |
| Jan-March 2010 | 31 penalties<br>29 warnings | 2 penalty<br>29 warnings | 5 penalties | 285, of which 112 in the Supreme Court |
| Oct-Dec 2009 | 31 penalties<br>15 warnings | 1 penalty | 2 penalties<br>9 warnings | 274, of which 108 in the Supreme Court |