FINANCIAL MARKET DEVELOPMENTS AND CHALLENGES IN BANGLADESH

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Acronyms

ADB	Asian Development Bank
SFYP	Sixth Five Year Plan
NSD	National Savings Directorate
DFI	Development Financial Institutions
NBFI	Non Bank Financial Institutions
MFI	Microfinance Institutions
SOCB	State Owned Commercial Banks
FCB	Foreign Commercial Banks
PCB	Private Commercial Banks
DSE	Dhaka Stock Exchange
PKSF	Palli Karma Shahayak Foundation
NPL	Non Performing Loans
FSRP	Financial Sector Reform Project
WB	The World Bank
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
IMF	International Monetary Fund
FSI	Financial Soundness Indicators
FAS	Financial Access Survey
GDP	Gross Domestic Product
QIS	Quantitative Impact Study
CAR	Capital Adequacy Ratio
MCR	Minimum Capital Requirement
MPS	Monetary Policy Statement
BOP	Balance of Payments
CPI	Consumer Price Index
ECF	Extended Credit Facility
FDI	Foreign Direct Investment
REER	Real Effective Exchange Rate
LIBOR	London Interbank Offered Rate
LC	Letter of Credit

MLM	Multilevel Marketing
MRA	Microcredit Regulatory Authority
NGO	Non Government Organizations
IDRA	Insurance Development and Regulatory Authority
KYC	Know-your-customer
IPO	Initial Public Offering
CAMD	Capital Adequacy and Market Discipline
ROE	Return on Equity
ROA	Return on Assets
SEC	Securities Exchange Commission
ICB	Investment Corporation of Bangladesh
CDS	Central Depository System
CDBL	Central Depository Bangladesh Limited
MA	Moving Average
CSE	Chittagong Stock Exchange
BCA	Banking Control Act
FRA	Financial Regulatory Act
MOF	Ministry of Finance
PD	Primary Dealers
SRO	Self-Regulatory Organizations
IAS	International Accounting Standards
DVP	Delivery versus Payment
CCP	Central Counter Party
OTC	Over the Counter
MOU	Memorandum of Understanding
BGTB	Bangladesh Government Treasury Bonds
SLR	Statutory Liquidity Requirement
CDMC	Cash and Debt Management Committee
PSDU	Pension Sector Development Unit
UNCDF	United Nations Capital Development Fund

FINANCIAL MARKET DEVELOPMENTS AND CHALLENGES IN BANGLADESH

I. INTRODUCTION

The financial sector is a vital part of an economy because of the role it plays in intermediating savings of the private and public sector to productive activities including investment. Bangladesh financial system is dominated by the banking sector, which fundamentally depends on short- and medium-term deposits for financing their lending portfolios. This limits availability of funds that would be required for long-term investments like infrastructure and housing. Bangladesh has a capital market, with its known difficulties, and there is no vibrant secondary market for bonds, which limits the availability of resources for infrastructure financing. This paper starts with a general overview of the current structure of the financial system in Bangladesh in terms of the 4 key markets—money market comprising banks, microfinance institutions and nonbank financial institutions, stock market, bond market and insurance market--and their sizes, relationships between the various markets and the associated regulatory bodies assigned to govern the different market segments.

It then analyzes recent performance of these markets by looking at their important constituents and identifies the key challenges these markets are facing which could undermine their intermediation role in allocating resources to the key sectors and activities to support achievement of the Seventh Plan objectives. In particular, intermediation of private financial resources through the banking system, and mobilization of resources for private investment through the capital and bond markets will be important for achieving the investment targets under the Plan. The paper then recommends for each of the markets the corrective reforms which will strengthen their operations and enhance/accelerate market development. As we are passing through the final year of the Sixth Five Year Plan (SFYP) period, the discussions will be cast in relevant cases against the objectives/targets established under the SFYP.

The remainder of the paper covers the following issues. Section II discusses the overall structure of the financial system, which is comprised of four main markets, their developments over time and relative size, and regulatory management. Monet market related issues are analyzed in Section III. This section provides an overview of past and recent developments in the banking sector of Bangladesh covering important issues such as structural reforms of 1980s and 1990s, indicators of banking sector performance, progress with Basel II and preparations for Basel III, monetary policy management of Bangladesh Bank, Interest rate related issues, developments in foreign exchange market, and impact of liberalization of foreign currency denominated borrowing on the banking system. This section also highlights the setbacks to the banking system due to banking scams and default loans, developments and outlook for microfinance institutions in Bangladesh, gains made in terms of financial inclusion, and developments and issues related to nonbank financial institutions. Section III also discusses the challenges and concerns relating to the banking sector and a comprehensive agenda for money market reform and operational improvements.

Section IV discusses capital or stock market related issues. It provides discussions on historical background of the capital market including the turbulent episode of 2009-14; and current state of the capital market in terms of key market indicators. This section also provide a discussions on the progress made with structural reforms in the post correction period and makes a number of recommendations based on capital market studies made in recent months.

Bond market related issues are covered in Section V. Following discussions on the current status of the bond market in Bangladesh, this section also focuses on constraints to development of the bond market and policy recommendations. This section also covers related issues like current status of pension funds in Bangladesh and prospects related to issuance of municipal bonds in Bangladesh. Specific policy recommendations relating to development of the overall bond market, pension funds, and municipal bonds are also noted in this section. Section VI covers issues related to the insurance market—its current state and the agenda for reform. Some concluding observations are presented in the final section (Section VII) of the study.

II. STRUCTURE OF THE FINANCIAL SYSTEM IN BANGLADESH

The financial system of Bangladesh is comprised of three broad fragmented sectors, Formal Sector, Semi-Formal Sector and the Informal Sector. The categorization is based on the extent of regulation in the sectors. The **formal financial sector** is comprised of money market (comprising operations of the banking system, microcredit institutions, nonbank financial institutions, interbank foreign exchange market), the capital market (stock markets), bond market and the insurance market. Operational activities of these institutions in the formal financial sector are governed by a number of regulators such as Bangladesh Bank (banking system), Securities and Exchange Commission of Bangladesh (regulating the stock market operations), Insurance Regulatory Authority (for insurance institutions), and Microcredit Regulatory Authority (micro credit institutions). Ministry of Finance also has some oversight role in certain aspects. The current size of the respective sectors measured in terms of asset base of the financial sector of Bangladesh is shown in Table 2.1.

Table 2.1: Size of Different Segments of the Financial System as Share of Total Assets of the Formal Financial Sector and as Percentage of GDP, June 2013

	Percentage Share in Total Assets of the Formal Financial Market	Size as Percentage of GDP
Banking Sector	63	60
Stock Market	20	19
Bond Market	16	15
Insurance Market*	3	3

*The figures for the Insurance Market are based on the data of year 2010 from Masuduzzaman, M., Rahman, M.H. and Ahammed, S. (2013). Integration of Financial Market and its implication of Stock Market Development in Bangladesh: An evaluation.

Source: Bangladesh Bank, DSE and BBS

The **semi formal financial sector** includes those institutions which are regulated otherwise but do not fall under the jurisdiction of Central Bank, Insurance Authority, Securities and Exchange Commission or any other enacted financial regulator. This sector is mainly represented by *Specialized Financial Institutions* like House Building Finance Corporation (HBFC), Palli Karma Sahayak Foundation (PKSF), Samabay (Cooperative) Bank, Grameen Bank, and financial activities/programs (lending and deposit taking) of various Non Governmental Microcredit Organizations. The **informal financial sector** includes private intermediaries which are completely unregulated and sometimes engaged in financial transactions not legally permitted. The formal financial market in Bangladesh comprises mainly of money market, stock market, bond market, insurance market, foreign exchange market and micro-financial market. The discussions of this paper will focus primarily on the formal sector of the financial market.

The financial market is dominated by the banking sector which is the most important part of the money market. The capital market makes up the second most significant segment of the financial system. The third most important segment of the financial system of Bangladesh is the bond market, dominated by treasury bills and saving instruments issued by the National Saving Directorate (NSD) of the Ministry of Finance. The insurance sector is quite old but its size is still relatively small.

III. MONEY MARKET

The major participants involved in the money market are scheduled banks, development financial institutions (DFI), non bank financial institutions (NBFI) and Microfinance Institutions (MFI). Banks play a dominant role in the financial market of Bangladesh. At present there are 56 scheduled banks operating in Bangladesh of which 4 are state-owned commercial banks (SCBs), 4 are government-owned specialized banks (SOCBs), 9 are foreign commercial banks (FCBs) and 39 are domestic private commercial banks (PCBs) including 31 conventional private commercial banks and 8 Islamic banks. The major source of funds of banks is collecting deposits in the form of demand and time deposits from the households, corporate and non-corporate private sectors, and public sector entities and government.

i) An Overview of Past and Recent Developments in the Banking Sector of Bangladesh

1. Structural Reforms of 1980s and 1990s

Bangladesh’s financial system was characterized as a very repressed financial system before the advent of reforms in the 1980s. Both the market and institutions, in the post-independence period faced major structural problems, evident both in the money market comprising the banking and other sectors as well as the capital market.

In order to counter these problems, the first round of financial sector reform was initiated in 1982 with the denationalization of some commercial banks, followed by the establishment of the

National Commission on Money, Banking and Credit in 1984. However, major reforms in the sector were launched much later in the early 1990s.

The banking sector, which was the dominant sub-sector of the country's financial system and still remains most dominant, has undergone major transformations through various reforms. The reform programmes initiated focused on several dimensions, namely privatization of state-owned commercial banks (SCBs) and entry of new private and foreign banks. Other areas the reforms were directed towards include: recovery of non-performing loans (NPL); interest rate deregulation; central bank's increased autonomy; strengthened prudential regulation and supervision; rationalization and merger of bank branches; and improvements in the functioning of the money market. As the views towards denationalization and private sector participation in the banking system changed, the initial phase of banking reform (1980-1990) focused on the promotion of private ownership of commercial banks and denationalization of some nationalized commercial banks (NCBs).

Table 3.1: Assets of the Banking Sector as on June 2013

Type of Banks	Non-Interest Operating Cost	Total Assets	Operating Cost as a % of Total Assets
State-owned Commercial Banks	1421.36	201315.32	0.706
Specialized Development Banks	829.59	42401.66	1.957
Private Commercial Banks	**5046.95**	**462820.63**	**1.090**
Foreign Banks	525.04	46112.57	1.139
Total	**7822.94**	**752650.18**	**1.039**

Source: Bangladesh Bank

It was not till the mid-1980s that banks felt the strong compulsion to adopt reform measures. Once the weakness of the sector was identified, the government privatized three nationalized commercial banks during 1984-86 and granted licenses to four private commercial banks in the early 1980s. This round of reform, however, did not bring about the desired improvements and was considered largely unsuccessful due to regulatory and supervisory weaknesses of Bangladesh Bank, abusing of the banks' assets by the newly private managements/owners of the private commercial banks (PCBs) and NCBs' interest groups which resulted in a loan default culture.

The unsuccessful results of the first round of reforms led to the adoption of wide-ranging banking reform measures under the World Bank's Financial Sector Reform Project (FSRP) in the 1990s. The focus of reforms, among others, has been on gradual deregulations of the interest rate structure, providing market-oriented incentives for priority sector lending and improvement in the debt recovery environment. Moreover, a large number of private commercial banks were awarded licenses in the second phase of reforms. Although second generation banks have addressed many demand side issues, such as, development of a wide range of financial products and services, the measures have not been successful in addressing the banking sector's key problems. These include high NPL ratios both in state and private banks and a lack of enforcement of the capital adequacy and the absence of firm supervision and effective enforcement of regulations by Bangladesh Bank.

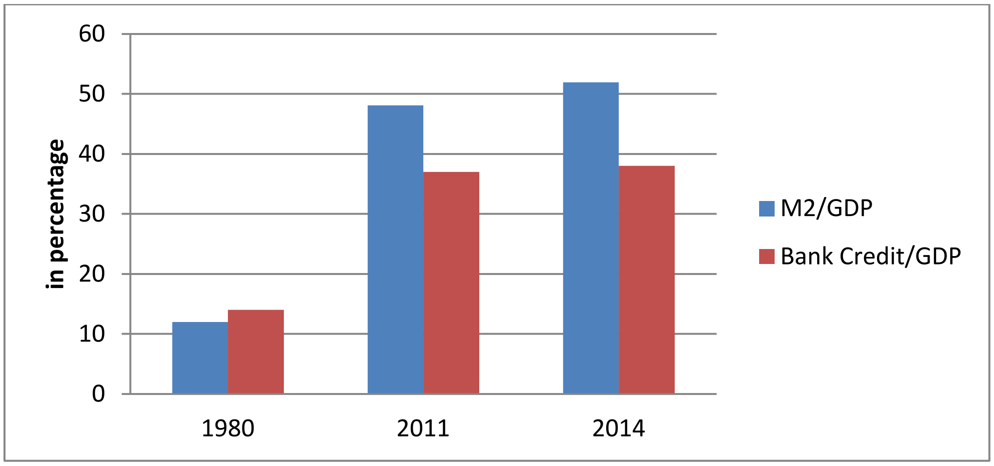
While the issue of regulation and supervision was spelled out in FSRP and the banks adopted Basel I norms (maintaining adequate capital to withstand crisis) in 1996, it was indeed the reforms in post 2000 that had a de facto focus on risk-based banking supervision. Moreover, the Central Bank Strengthening Project initiated in 2003 focused on effective regulatory and supervisory system for the banking sector, particularly strengthening the legal framework, automation and human resource development and capacity building of BB.

The Enterprise Growth and Bank Modernization Project was adopted in 2004 by the WB to help the government achieve a competitive private banking system through a staged withdrawal through divestment and corporatization of a substantial shareholding in the three public sector banks (Rupali, Agrani and Janata), and divestment of a minority shareholding in the largest state bank, Sonali. Ths program however did not achieve much success due to resistance from within and political changes afterwards.

2. Some Important Indicators of Banking Sector Performance

In terms of its banking sector performance Bangladesh has done well overall despite some setbacks in the area of public banking. Banking reforms which started in early 1980s, but gathered momentum in the 1990s and 2000s, have brought about positive changes in most of the indicators of banking performance. Much of the serious reforms that impacted on the quality and health of the banking sector happened after 1999. Indicators like the broad money (M2) to GDP ratio, which is often used as an indicator of the depth of the financial sector, has risen from 12% in 1980 to 57% in June 2012, along with total bank credit as a share of GDP has grown from 14% to 55% over the same period. In the absence of a well developed capital market, the growth in private credit has played a major role in supporting the expansion of the private sector in Bangladesh.

Figure 3.1: Indicators of Growth of Banking Activities



Source: Bangladesh Bank

The positive gains in financial deepening notwithstanding, a comparison with the regional comparator countries clearly indicates that Bangladesh is still very much behind most regional comparators, except Pakistan. Bangladesh lags behind India in terms of financial deepening and well behind countries like China and Vietnam.

Table 3.2: Indicators of Banking Activities for selected countries (2013)

	M2/GDP	Bank Credit/GDP
China	194.5	140.0
India	77.4	51.8
Pakistan	40.2	15.6
Vietnam	117.0	96.8
Bangladesh	70.8	48.0

Source: World Development Indicators, World Bank and Financial Soundness Indicators, IMF

One of the most important indicators of the health of the banking sector is the Non-Performing Loan (NPL). Table 3.3 shows that there was a sharp decline in the share of non-performing loans (NPLs) from a high of 41% in 1999 to the lowest point of 6.1% in June 2011 but it has been on the rise ever since. What was a major positive development for the banking sector, was turned upside down by the banking scams. There are still some serious concerns about the portfolio quality of the public sector banks that are not properly reflected in the data. Both SCBs and PCBs recorded impressive improvements in terms of addressing the NPL problem. In particular, the NPL ratio of private banks declined to less than 3 percent in 2011, compared with more than 27% in 1999 but increasing to 5.7% in 2014.

Improvements have also been made in meeting capital adequacy requirements with the industry-wide risk-weighted capital adequacy ratio exceeding 11% as of June 2011. The risk weighted capital adequacy ratio of SCBs also increased to 11.7% in 2011 from only 5.3% in 1999, in part supported by recapitalization of these banks by the government to meet the capital adequacy requirement stipulated under the Banking Act. The year 2011 was of significance given the favorable outcomes of the banking sector indicators in the post-reform scenario.

Table 3.3: Indicators of Health of the Banking Sector (Percent)

Indicators	1999 (Pre-Reform Baseline)	2011 (the comparator best year)	2014 (Latest Available[1])
Share of Non-Performing Loans: Overall	41.1	6.12	10.75
Share of Non-Performing Loans: Private Banks	27.1	2.95	5.7
Share of Non-Performing Loans: Foreign Banks	3.8	2.96	6.19
Share of Non-Performing Loans: State Commercial Banks	45.6	11.27	23.23
Share of Non-Performing Loans: Public DFIs	65.0	25.55	33.12
Risk-weighted Capital Ratio: Overall	7.4	11.35	10.68
Risk-weighted Capital Ratio: Private Banks	11.0	11.49	12.05
Risk-weighted Capital Ratio: Foreign Banks	15.8	20.97	20.61
Risk-weighted Capital Ratio: State Commercial Banks	5.3	11.68	8.65
Risk-weighted Capital Ratio: Public DFIs	5.8	-4.49	-13.68

Source: Bangladesh Bank

Profitability of banks measured against the rates of return on assets and equity had experienced a decrease, with the only exception being the foreign banks. Foreign banks have shown positive outcome in terms of profitability, with their return on assets increasing from 3.24% to 3.48% and return on equity increasing from 16.58% to 20.14% from 2011 to 2014 respectively. Table 3.4 shows the Return on assets and equity of the banks.

Table 3.4: Profitability of the Banking Sector (Percent)

Types of Banks	**Return on Assets**			**Return on Equity**		
	1999 (Pre-Reform Baseline)	**2011 (the comparator best year)**	**2014*(Latest Available)**	**1999 (Pre-Reform Baseline)**	**2011 (the comparator best year)**	**2014*(Latest Available)**
All Banks	0.2	1.54	0.61	5.24	17.02	8.36
Private Banks	0.8	1.59	0.78	15.32	15.69	8.4
Foreign Banks	3.5	3.24	3.48	41.84	16.58	20.14
State Commercial Banks	0	1.34	-0.09	-1.08	19.66	-2.35
Public DFIs	-1.6	0.03	-0.87	-29.4	-0.92	-9.46
* The figures for 2014 are provisional and till June 2014						

Source: Department of Off-site Supervision, Bangladesh Bank

[1] The figures given are till June 2014.

Table 3.5: Performance Indicators of the Banking Sector in Selected Countries (2013)

Country	Share of Non-Performing Loans	Risk-Weighted Capital Ratio	Return on Assets	Return on Equity	Liquid Assets to Total Assets
China	1.0	12.2	1.30	19.2	21.2
India	4.0	12.3	0.7	10.8	8.1
Pakistan	3.1	14.9	1.1	12.4	47.3
Vietnam	3.61	13.25	0.49	5.18	13.4
Bangladesh	2.01	11.52	0.9	10.7	25.6

Source: Reports of various Central Banks & Financial Soundness Indicators , IMF

The coverage of the banking sector also compares favorably with Pakistan but as evident from Table 3.6, Bangladesh is far behind emerging nations like China and India.

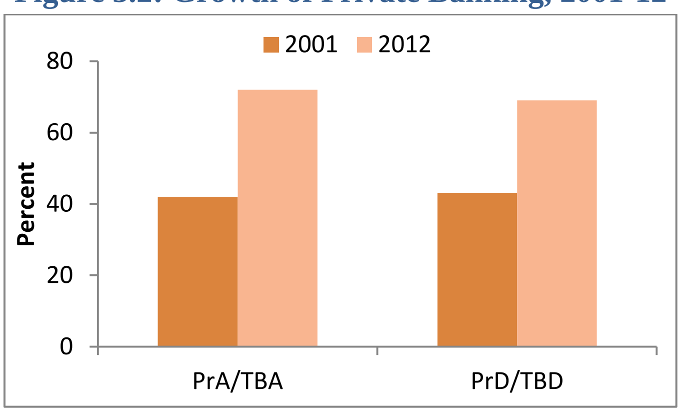
Table 3.6: Banking Sector Coverage Indicators for Selected Countries (2013)

Country	Number of Commercial Banks	Number of Commercial Bank Branches	Number of Automated Teller Machines (ATMs)
China	204	86708	519996
India	157	105933	115849
Pakistan	38	10943	7634
Vietnam	47	2497	15265
Bangladesh	56	8342	6797

Source: Financial Access Survey, IMF

The three main factors that contributed to the improvement in the coverage of the banking sector of Bangladesh are greater competition for market share, better regulations and improved supervision. The opening up of the banking sector to private enterprises was perhaps the most determining factor. As a result of this competition the share of private banks in total assets has grown from 42% in 2001 to 72% in June 2012; commensurately, its share of total deposit has expanded from 43% to 69% over the same period (Figure 3.2).

Figure 3.2: Growth of Private Banking, 2001-12



Source: Bangladesh Bank.

Competition amongst private banks and between private and public banks caused a massive increase in financial resource mobilization, introduction of new financial products and substantially better service to customers. While still catching up with international standards, nevertheless intense competition in retail banking has caused a huge improvement in banking services not only in terms of faster turn-around time for transactions but also in terms of access to modern banking facilities such as ATMs, e-banking, credit/debit cards, wire transfers, etc.

Importantly, this transformation was instrumental in improving the health of the banking sector. Thus, to a large extent the improvement in total banking sector NPLs happened due to the rising share and much better portfolio quality of private banks. Within private banks, foreign banks performed better in terms of NPLs. Furthermore, foreign banks substantially surpass the Basel II risk weighted capital guidelines, making them the safest banks in the industry.

Banking regulations have been progressively tightened in the context of implementation of BASEL I and II guidelines. Efforts have also been made to improve the supervision capacity of the regulator, the Bangladesh Bank, through a range of technical assistance from the IMF and the World Bank.

3. Progress with BASEL II and Preparations for BASEL III

Given the numerous limitations of BASEL I, the Basel Committee released International Convergence on Capital Measurement in 2004 indicated the new capital adequacy framework of BASEL II. This was revised in June 2006 and made effective from 2006 (with parallel run) and in Bangladesh it ran with effect from 2009. Under BASEL II the following features of Capital Adequacy Framework is to be considered along with three dimensions: Minimum Capital Adequacy Requirement, Supervisory Review and Market Discipline and some additional features that involve strong emphasis on Risk Management. Bangladesh Bank has implemented it from the beginning of 2009 and after conducting a Quantitative Impact Study (QIS) to see the impact, has decided to adopt a standardized approach for credit risk and a Basic Indicator Approach for Operational Risk. With regard to this, a road map was circulated, a mid level Coordination Committee was formed, a Basel II implementation cell was established and all banks were asked to form Basel-II implementation Committee. Bangladesh Bank had directed all scheduled banks to implement capital adequacy ratio (CAR) and minimum capital requirement (MCR) in three phases starting from January 2010. The scheduled banks were to maintain CAR not less than eight percent between January 01, 2010 and June 30 and the CAR were to increase at least to nine percent between July 2010 and June 2011 and to 10 percent by July 2011 and onwards. The MCR must be eight percent of a bank's risk weighted assets by June 30, 2010, nine percent by June 2011 and 10 percent from July 2011 onwards.

Bangladesh has started preparation to implement the BASEL-III framework for bank companies from 2014 in line with the global standard. BASEL III, once implemented effectively, should have a tremendous impact on the financial system and economy of Bangladesh. On one hand stronger capital and liquidity requirements should make Bangladesh's banking sector much safer while on the other hand, extra safety would also mean extra costs for the bank. Loans and other services provided by banks will become somewhat more expensive and harder to obtain. The challenges in implementing the BASEL III framework are not to be ignored either especially in areas such as augmentation of capital resources, growth versus financial stability, challenges for enhanced profitability, deposit pricing, cost of credit, maintenance of liquidity standards and strengthening the risk architecture.

4. Bangladesh Bank and Monetary Policy Management

Background

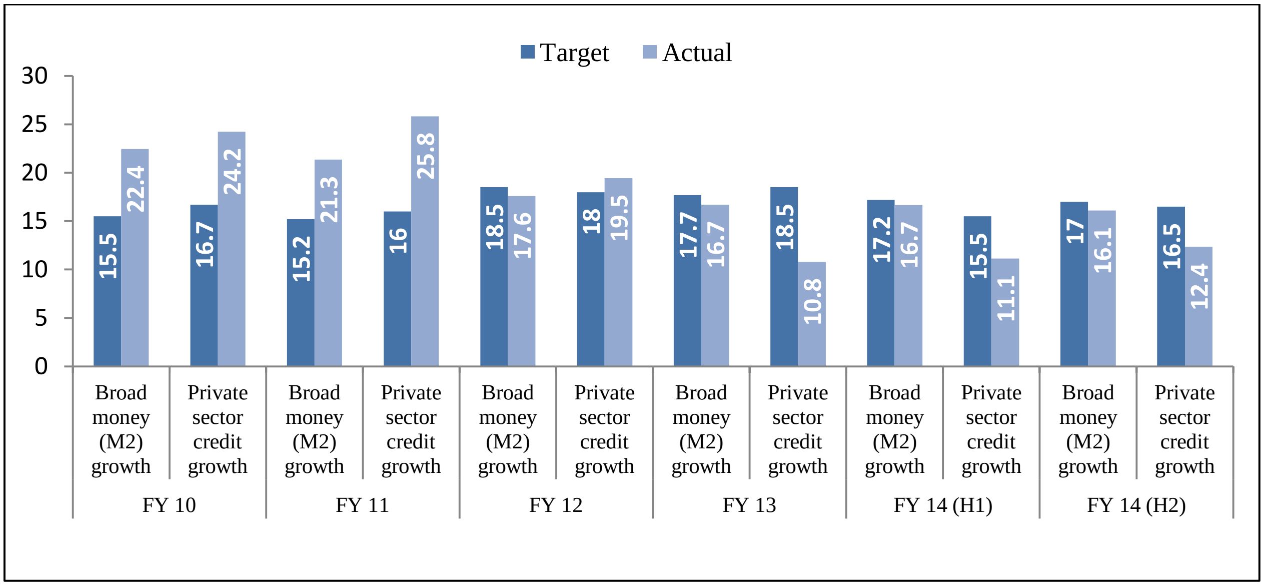
In order to tackle the growing inflationary pressure and increased balance of payments vulnerability, Bangladesh Bank announced a shift in its monetary policy stance in January 2012. By November 2011, the general inflation reached almost 12%, the highest level since 1998, and government borrowing from the banking system to finance budgetary operations already crossed the borrowing limit established in the budget for the whole year. Increased import payments associated with higher petroleum prices and volume of imports, started to exert pressures on the exchange rate and the level of foreign exchange reserves in the second half of 2011.

Taking these developments into account, Bangladesh Bank's Monetary Policy Statement (MPS) of January 2012, stated to "pursue a restrained monetary growth path consistent with curbing inflationary and external sector pressures, while ensuring adequate private sector credit to stimulate inclusive growth." Following successive years of significant deviations between the announced MPS stances and their implementation, in the guise of so called "accommodative" monetary policy, initially there was a certain amount of skepticism about Bangladesh Bank's resolve in pursuing a restrained monetary policy in line with the quantitative monetary targets. There was also widespread realization that BB's inability in the past to firmly adhere to its announced MPS quantitative targets had fueled inflation, created asset market bubbles, and weakened Bangladesh's BOP position. **The tightening of monetary stance we saw in FY11 was partly a response to contain domestic demand and inflation, and help stabilize the balance of payments.**

Execution of Monetary Policy in Recent Years

BB generally recognized the imperative for prudent monetary policy and accordingly established quantitative targets for key monetary aggregates in each and every MPS in recent years. However, actual implementation initially (FY10-12) fell well short of the requirement. BB put a cap on the lending rate of commercial banks and did not respond forcefully when monetary aggregates exceeded the intended levels by wide margins. BB characterized this policy stance as "accommodative" to meet the credit needs of a growing economy. As a result, most monetary targets were exceeded by wide margins every year during FY10-12.

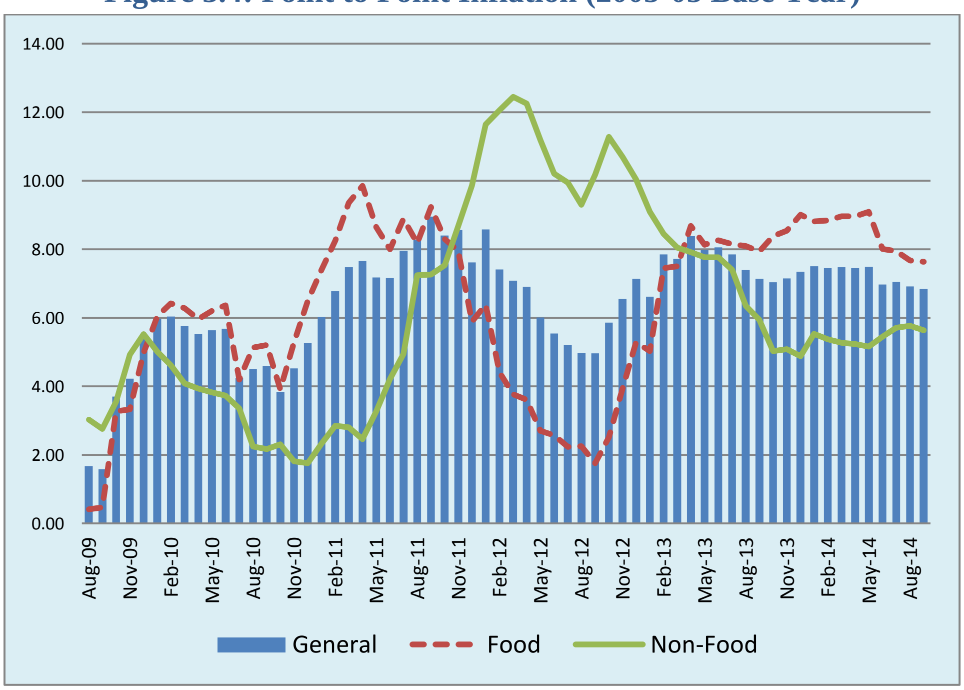
Figure 3.3: Monetary Policy Targets Vs Actual, in Recent Years



Source: Bangladesh Bank

The destabilizing impact of such monetary expansion was visible on both domestic and external fronts. On the domestic front, a sharp rise in inflation and asset prices essentially resulted from excess liquidity in the economy. CPI inflation reached almost 12% in September 2011 on a point-to-point basis which was highest since 1998 (based on the 1995 base old index of that time).

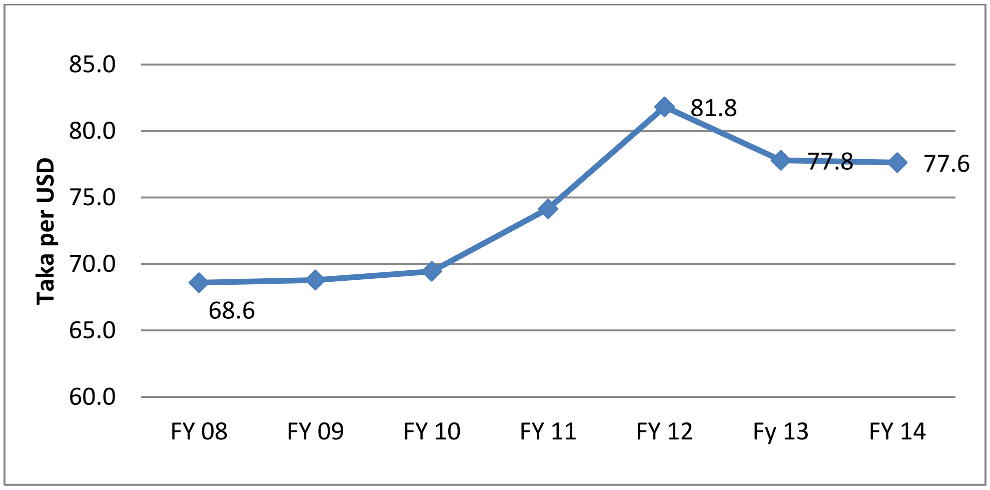
Figure 3.4: Point to Point Inflation (2005-05 Base Year)



Source: BBS

The impact of monetary expansion on asset prices was quite costly for the economy. The liquidity expansion helped create a large bubble in the already overvalued capital market. Real estate prices also experienced an unprecedented surge. On the other hand, significantly higher inflation than Bangladesh's major trading partners reduced competitiveness of domestic products and made imports cheaper in real terms. These developments, coupled with increased domestic demand due to monetary expansion above reasonable levels, widened the trade deficit. The resulting balance of payments pressure contributed to a marked depreciation of the Taka, following a substantial period of relative exchange rate stability.

Figure 3.5: Exchange Rate Movements, FY08-14



Source: Bangladesh Bank

Against this backdrop, the need for monetary tightening became pressing by end-February 2011. Although somewhat late, BB took a series of monetary tightening measures and allowed the exchange rate to move freely. In response, private sector credit growth started declining beginning in the last quarter of FY11. These tightening measures helped contain the expansion of monetary aggregates close to the monetary targets of BB for end-June 2012.

Is the Tightened Monetary Policy Working?

The objective of monetary tightening was to restore both internal and external imbalances by taming inflation and thereby also stabilizing the exchange rate. From the Figure 3.4 we can see that inflation has been trending downward and steadily came down through FY14. Growth in import payments decelerated sharply despite much higher oil-related payments. As shown in Figure 3.5 after a sharp depreciation of the Taka, the exchange rate has appreciated and then remained stable until now (November 2014).

Since the shift In the monetary policy stance in early 2012, BB adhered to the monetary targets stated in the MPS and the ECF arrangement with the IMF, and maintained a similar policy stance through September 2014, bringing the inflation rate down to the target level of 6.5% in most recent months. Continued prudent monetary tightening and favorable external environment would be preconditions for realizing the inflation objective set under the July –December 2014 MPS.

Future Challenges and Recommendations for Monetary Management

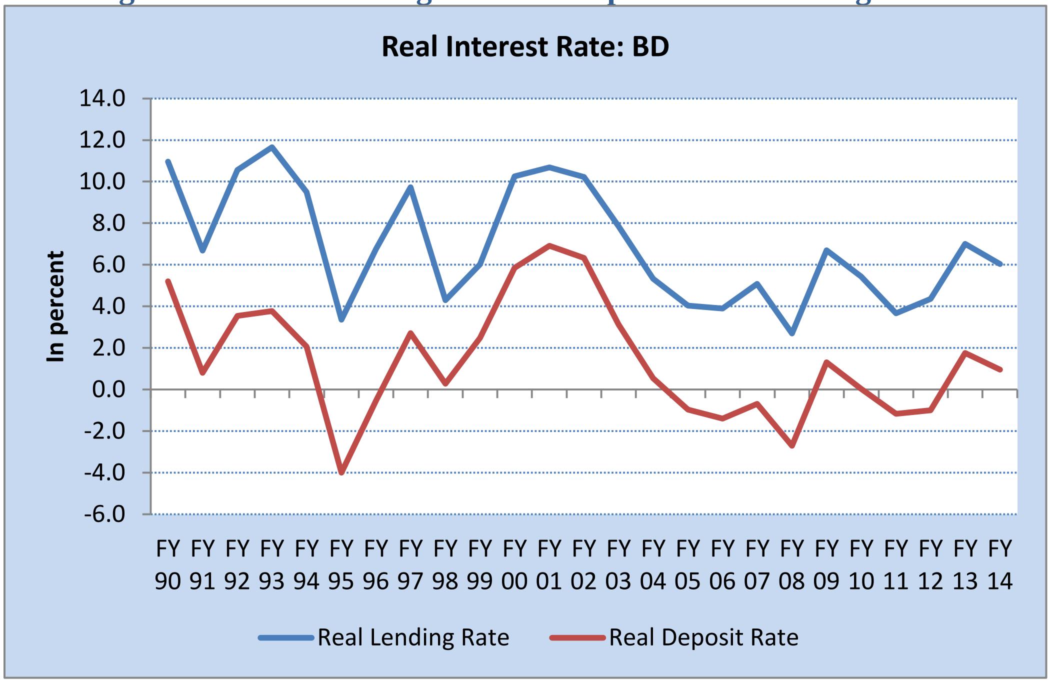
Monetary development since January 2011 has been moving in the right direction to achieve the MPS targets and quantitative limits established under the ECF. In its monetary policy operations **BB should focus primarily on the quantitative targets and not on policy instruments like interest rates.** It is beyond the capacity of any central bank to influence or target both, and BB is no exception. Like most developing countries, transmission of monetary policy is considered inefficient in Bangladesh. **Development of the treasury bills and bond market will be keys to enhance the transmission mechanism.**

5. **Interest Rate Structure: Developments and Issues**

There is widespread allegation from the business community that bank interest rates and charges in Bangladesh are too high. They also feel that high interest rates have adversely impacted investment and domestic economic activity. This an important national policy issue and will require careful review of many related aspects of our economy before making an informed policy decision in this regard. We also need to understand that the interest rate structure at any particular time is dependent on both short-term developments/considerations and structural aspects of the economy and the banking system. Short-term developments/considerations which impact the interest rate structure generally include: levels of domestic inflation; developments in the external accounts (balance of payments); speculative pressures in the foreign exchange market (as happened recently in India); crowding out of the private sector by government borrowing; etc. Structural issues impacting the interest rate structure generally include: efficiency of the banking system (administrative cost, efficiency in managing loan/investment portfolio with proper balance between risk and return, return on capital etc.); openness of the financial market (capital account openness); state of development of the financial system including bond market; etc.

A review of long term historical data on interest rates: Nominal average lending rate was 13.79% in FY13. In the period prior to financial sector reform which was initiated in early 1990s, there was widespread financial repression with real rates of return for depositors significantly negative and real borrowing/lending rates were generally well below 5% level. Average real rate of return on deposits became positive, albeit at an average of 2.4% during FY91-04 and the real lending rate on average also increased to 8.1% level over the same period.

Figure 3.6: Real Lending and Real Deposit Rates of Bangladesh

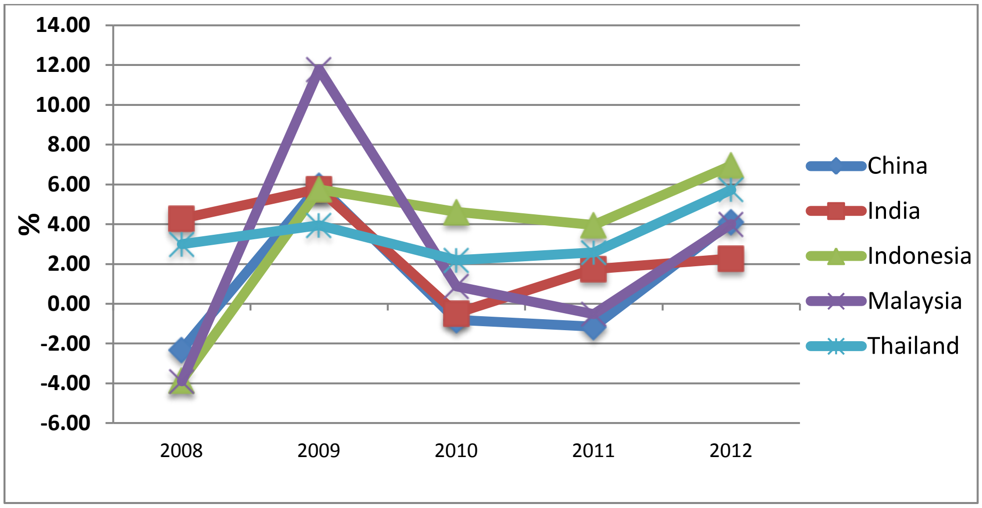


Source: Bangladesh Bank.

In recent years (FY03-FY13), with inflation rate increasing, the average real deposit rates became negative (-0.72%) and the real borrowing rate averaged at 4.53%. As the inflation rate decelerated in FY13, the average deposit rate became marginally positive (1.5%) and the real borrowing rate increased to 6 percent. The spread between lending and deposit rate however declined modestly in FY 13 to 5.3 percentage points. The narrowing of spread however reversed and the spread started to widen in FY14 in part due to the effect of growing nonperforming loans.

Real Interest Rate of Bangladesh Compared to that of Other Countries: Bangladesh's real interest rate is not out of line with many other comparator countries. However it is worth mentioning that depositors getting negative real rate of return on average are not good for savers. Borrowers are getting funds in real term that is less than the spread charged by banks, which is coming at the expense of savers. Countries with higher interest rate than Bangladesh include Indonesia and Thailand. India has the lowest real interest rate because of its high inflation. This very low real interest rate is one of the factors contributing to excess demand, high inflation and balance of payment problem recently experienced in India.

Figure 3.7: Real Lending Rate of Selected Comparator Countries



Source: World Bank

Developments in Interest Rate Spread and Its Determinants

Following an increase in the interest rate spread since June 2011, the spread has started to decline modestly since June 2012. Developments in the interest rate spread in recent years indicate that, it generally remained above 5%. As Bangladesh Banks fight against inflation started to bring inflation down, the tightening of monetary stance started to ease and the average lending rate started to decline with a consequent decline in the interest rate spread. A sustained reduction in the inflation rate should help reduce the overall interest rate structure starting with the lowering of deposit rates, but should not impact the real interest rates.

As of August 2013, the interest rate spread declined to 5.0%, with both deposit and lending rates showing modest downward trends. This was broadly in line with the easing of monetary/credit condition at that time with inflation coming down toward the target level. However the spread started to widen in recent months despite efforts by Bangladesh Bank. In a well managed and relatively efficient banking system the level of spread could be as low as below 3%, compared to 5% or more for Bangladesh. The higher spread in Bangladesh is thus a manifestation of structural weaknesses or inefficiencies of the banking system as a whole. The spread could be explained by developments in four major components discussed below.

Administrative costs of banks such as operating expenses, excluding interest cost, are generally a component of the spread. Bangladesh Commercial Banks' operating costs excluding interest payments on deposits generally ranges between 0.7% of its asset base for state owned commercial banks to 1.4% for foreign commercial banks. Although not very high, when compared with countries with more efficient financial system and lower spread, there is scope for some improvement in this area.

Provisioning requirements associated with classified/bad loans always significantly affect the interest rate spread. Bangladesh's Gross and Net NPL ratios have always been quite high relative comparator countries. In particular, the very bad asset quality of state-owned banks has caused the gross NPL ratio to increase to 10.75% of assets in FY14 Even the private commercial banks have suffered a reversal in gross NPL since December 2011. From a low of 3%, the Gross NPL of commercial banks in FY11 increased to 5.7% of assets by June 2014. Recent rapid deterioration NPLs, particularly due to the excessive and imprudent lending and the recent collapse of stock market and real estate and land prices, continue to adversely impact lending rates and charges imposed by commercial banks. Corporate tax rate applied on pre-tax profits of commercial banks also impact interest rates. Bangladesh's corporate tax rate on banks at 42.5% is the highest in the region and adds to the wider spread.

There are three key parties/players engaged in the operations of the banking system: depositors; banks as the financial intermediary; and borrowers using the intermediated savings for investment and trading activity. For healthy growth in domestic savings and the deposit base, banks need to offer at least marginally positive real interest rates to the depositors. This means that for any significant reduction in the nominal deposit rate the domestic inflation rate needs to be brought down further. At the same time Bangladesh's very high GNPL--at more than 12% compared with only 1%-3% for countries like China, Malaysia, Indonesia, Thailand and India--points to the fact that inefficiencies in our financial intermediation will continue to adversely impact the spread and the borrowing rate. Banking sector governance and supervision must be strengthened significantly if Bangladesh Bank and the Government are serious about reducing the lending rate significantly without creating market distortions. Bangladesh Bank also needs to work on reducing the inflation rate further to 5% or less if it really wants to support a reduction of the nominal interest rate structure in a sustainable manner.

6. Foreign Exchange Market

Structure of Foreign Exchange Market

Foreign exchange market in Bangladesh is dominated by the interbank foreign exchange market where most export proceeds and other foreign exchange earnings like workers' remittances repatriated through the banking channel and services and capital account receipts are transacted. The other recognized but somewhat informal foreign exchange market is the parallel market which is primarily supplied by cash carried by incoming non-resident Bangladeshi and foreign visitors. Although Bangladesh allows for current account convertibility with some limits, the parallel market operates primarily because of continued capital account restrictions, particularly for outward transfer of capital.

The volume of transactions in the interbank foreign exchange market is primarily determined by the underlying trade related transactions. Trade in goods and services creates bulk of the transactions, while capital and financial accounts related transactions are relatively modest and until recently dominated by the public sector related transactions (such as borrowing from and debt servicing to official multilateral and bilateral organizations). While still small, this market segment is likely to grow over time with increasing FDI and portfolio investment in Bangladesh and liberalization of foreign currency denominated borrowing by the domestic private sector.

The FX derivative markets, such as futures, options, swaps, etc., are permitted for transaction. The FX market was extremely active in Bangladesh in recent years and almost 90 percent of inter-bank FX transactions were done in US dollar. The monthly average turnover of inter-bank FX transactions was USD 387.4 million in CY13, which was USD 448.2 million in CY12 and USD 223.4 million in CY11. The monthly average trade volume almost doubled in CY12, but decreased by 13.6 percent in CY13 compared with the preceding calendar year. Political turbulence during CY13 and associated economic slowdown probably contributed to the lower volume of trade in the FX market in CY13.

Table 3.7: Monthly average turnover of interbank FX transactions (USD million)

	CY11	**CY12**	**CY13**
Monthly average turnover of interbank FX transactions (USD million)	223.4	448.2	387.4

Source: Forex Reserve and Treasury Management Department, Bangladesh Bank

With rapid growth in receipts from foreign trade (receipts from exports of goods and services accounts of the balance of payments) and inflow of workers' remittances supplies of foreign exchange has increased significantly. On the demand side, import payments generally account for the bulk of demand for foreign exchange, while services accounts payments are also increasing quite rapidly. Since bulk of the transactions in the interbank foreign exchange market is trade backed, day-to-day movements in the exchange rate are limited and the underlying trend is essentially driven by movements in the external current accounts balance of the BOP.

Bangladesh foreign exchange market is in many respects very old-fashioned with almost all transactions done in the spot market at spot exchange rates. The forward market for foreign exchange exists, but very limited and for a relatively short period like 3 to 6 months.

Recent Nominal and Real Effective Exchange Rate Movements

In its latest Monetary Policy Statement (January-June 2014), Bangladesh Bank (BB) aimed to preserve external sector stability, building up reserves and avoiding excessive volatility of the exchange rate. Improved external balances are reflected in the accumulation of international reserves of about USD2.8 billion during second half of FY14 with gross reserves increasing to

US$21.6 billion at the end of June 2014, sufficient to cover more than six months of projected imports.

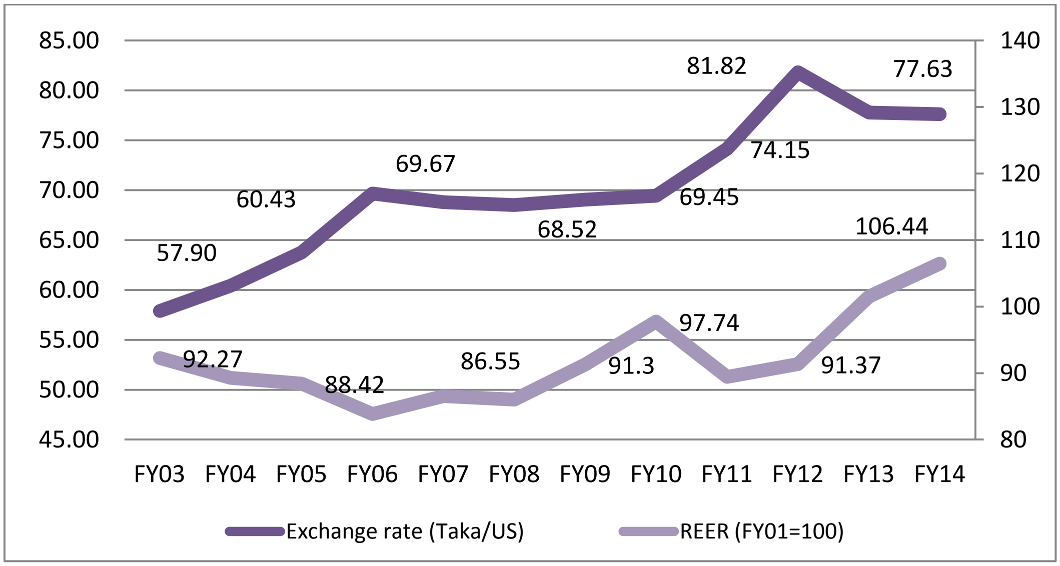
However, large surpluses in the external current accounts and the overall balance of the BOP in recent years have led to an oversupply of dollars in the foreign exchange market and the exchange rate would have appreciated significantly in nominal terms against the US dollar unless Bangladesh Bank continued to absorb the excess dollars from the market to maintain exchange rate stability in nominal terms. The main imperative for such an intervention was to protect the competitiveness of Bangladeshi exports in an environment when exports are declining in recent months and the RMG sector is yet to come out of the fallout from the Rana Plaza disaster. Bangladesh Bank's stance on preventing an appreciation of the nominal exchange rate is understandable because of the facts that the export sector had suffered financial losses due to the intensified political disturbances in the second half of 2013 and wage pressures and industrial unrests in the RMG sector.

The prolonged and sizable exchange market intervention by BB complicated monetary management through injection of liquidity in the system. In order to adhere to the inflation objective under the MPS and the underlying monetary targets, BB had to mop up the excess liquidity by issuing Bangladesh Bank bonds at appropriate market interest rates. This mopping up operation helped contain expansion of monetary targets and all key monetary indicators were within the targets set under the MPS of BB. The restrained monetary policy has helped BB to bring down inflation significantly in recent months, although it missed the inflation target by a relatively modest margin. At the same time the quasi-fiscal cost associated with the sterilization operation eroded BB's profitability since it earns much less on its foreign assets compared with what it pays on its domestic liabilities (such as BB bonds).

This tension between the exchange rate management and monetary management would continue until domestic demand remains subdued causing slower growth in import payments. Once domestic economic activity and investment start to rebound, growth in import payments will accelerate, there will be no need for monetary intervention or sterilization.

The other interesting and at the same time disturbing part of exchange rate management development was that while BB was successful in keeping the exchange rate of the Taka very stable against the dollar, the Real Effective Exchange Rate (REER) of Taka appreciated significantly, eroding the competitiveness of exporters. The relatively high domestic rate of inflation, compared with the inflation rates of Bangladesh's trading partners, has contributed to the appreciation of the REER of Bangladesh Taka and erosion of export competitiveness. BB's own calculation indicates that the REER index of Taka appreciated from below 89 in FY11 to more than 106 in FY 14, entailing more than 19% erosion of export competitiveness. Certainly, this situation is not sustainable and something must change: (i) either domestic demand must pick up through higher investment and consumption to depreciate the Taka in the interbank market; and/or (ii) the rate of inflation must come down sharply to levels broadly in line with Bangladesh's trading partners. Certainly, the policy of keeping the nominal exchange rate virtually fixed while the inflation rate is much higher than its trading partners is not sustainable for long.

Figure 3.8: Nominal Exchange Rate and Real Effective Exchange Rate Trend of Bangladesh Taka



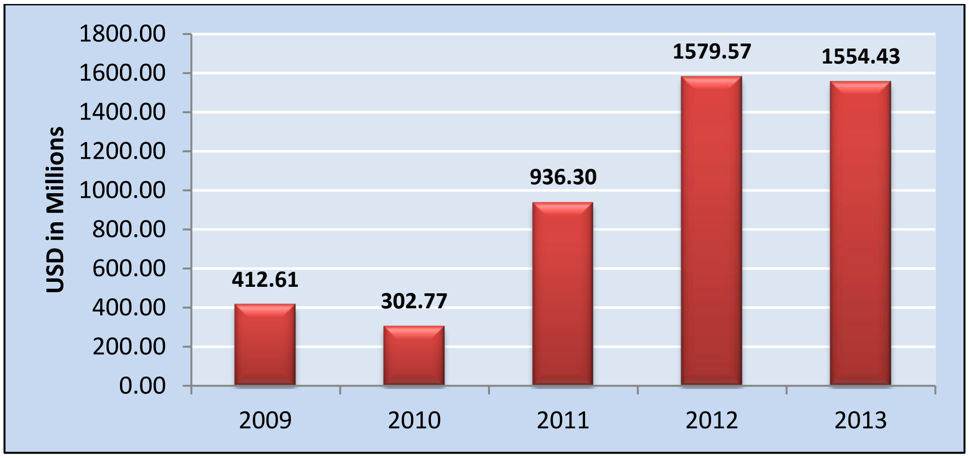
Source: Bangladesh Bank.

7. Impact of Liberalization of Foreign Currency Denominated Borrowing on the Banking System

Foreign Currency Denominated Borrowing by the Domestic Private Sector

Borrowing from international market by the domestic private sector in Bangladesh was highly controlled and virtually non-existent even a decade ago and access to foreign financing by the private sector was strictly controlled. Until 2008, the domestic private sector, barring some special cases/circumstances, were not allowed to borrow from foreign sources, even though foreign borrowings could be made at lower lending rates than those charged by the domestic banks and other financial institutions. Following an improvement in the foreign exchange reserve position of Bangladesh Bank, the government decided to liberalize such borrowing in the year 2008 primarily for the import of capital goods of new projects and modernization of existing projects, and for sectors defined in the country's industrial policy. In the past six years the central bank allowed private firms to borrow $5.56 billion from foreign sources at lower interest rates of around 5%-6%. In its monetary policy for July-December FY15, the central bank set the private sector indicative credit growth at 16.5 percent for the second half of the year, with 2.5 percentage points of that coming from foreign borrowing.

Figure 3.9: Total Approved Foreign Loan to the Private Sector



Source: Bangladesh Bank.

The total loan approved for private sector in Bangladesh has been increasing consistently from 2009 onwards. The total approved loan increased from $0.412 million in 2009, to $1.55 billion in 2013, which is an increase of 277%. From 2011 onwards, the approval process for loans has increased significantly which indicates that the central bank is actively trying to open up foreign financing sources for the private sector. A sectoral classification of the foreign loan portfolio of the private sector from 2009-2014 shows that the sector that received the highest amount was the telecommunication/ISP sector which accounted for 42.6% of the total. The second and third highest loan amounts was received by the Power and RMG/Related products sector, which accounted for 18.6% and 12.5% of the cumulative loans for the period. The highest recipient of foreign loans, the telecommunication/ISP sector, is exposed to relatively less risk due to most of them being parented by large international conglomerates. In comparison, most of the power sector and RMG sector projects are owned domestically.

Table 3.8: Sector-wise Distribution of approved loan (2009-2014)

	Number of Companies	**Total Sector wise Approval (USD in millions)**	**Sector wise loan as % of Total**
RMG/Related Products	98	693.7	12.5
Power	22	1028.8	18.6
Telecommunications/ISP	11	2356	42.6
Agriculture Products/Dairy Products/Food & Allied	11	127.2	2.3
Pharmaceuticals/Healthcare	8	140.5	2.5
Cement	7	85.5	1.5
Shipping, Water Transport. Cargo Handling	5	111	2.0
Packaging	4	6.2	0.1
Footwear	3	20	0.4

Table 3.8: Sector-wise Distribution of approved loan (2009-2014)			
	Number of Companies	**Total Sector wise Approval (USD in millions)**	**Sector wise loan as % of Total**
Electronic Goods Manufacturing	3	34	0.6
Air Transport	3	98.9	1.8
Steel	3	232.5	4.2
Conglomerate	1	365	6.6
Other	24	236.8	4.3
Total	**203**	**5536.1**	**100**

Source: Bangladesh Bank.

A study conducted by Bangladesh Bank on the foreign borrowing by the private sector indicates that while the amount of loans approved has increased significantly in the last five years, the amount of loans disbursed has in fact declined. The total loan approved for 2012 was $1.58 billion of which on $0.528 billion was disbursed, the amount disbursed in 2013 was $0.393 billion while total approved loan was $1.55 billion. The low disbursement rate of 35% and 25.3% for the two years is a cause for concern, as it indicates weakness on the part of potential borrowers in terms of their ability to meet the pre-conditions of the loans.

A survey report of Bangladesh Bank states that these loans were mostly been used for importing foreign capital machineries, expansion of existing projects and establishing new ones. The survey pointed to three major potential/actual difficulties in external borrowing:

- **Exchange rate fluctuations:** Companies which are not export oriented do not earn in foreign currency. Hence unfavorable exchange rate fluctuations lead to losses in local currency when servicing their foreign currency denominated loans.
- **Borrowing from off-shore banking unit:** One company which borrowed from the off-shore banking unit of a local bank, faced significant losses as the bank was unable to continue foreign exchange financing and switched to higher cost local financing.
- **Lengthy procedures for loan approval:** The loan application and approval process takes considerable time, which acts as a hindrance for some companies which require financing urgently.

Effectiveness of Liberalization of Foreign Currency Borrowing

The main reasons for the private sector to seek foreign loan is the interest rate differentials between foreign currency denominated (international) borrowing and taka denominated borrowing from domestic banks. Interest rates charged on foreign currency denominated loans provided to the private sector are generally set in the range labor plus 3%-4.5%, the spread over LIBOR (at 3%-4.5%) being the combined mark-up charged by the facilitating domestic commercial banks and the counterpart foreign lenders. The domestic lending rates at present vary between [11%-15%] depending on the customer, which is very high and is acting as a deterrent for investment and private sector borrowing. In terms of foreign rates, there are two main contributing variables--the LIBOR and the exchange rate between US Dollar and Bangladeshi Taka.

The 1-year Libor on October 21, 2014 was 0.55%, and a look at the historical trend for the past few months shows that the rate has been relatively stable. In terms of exchange rate depreciation, during 1990-1999 the decadal annual average change in the exchange was about 4%. The average annual rate of depreciation of the Taka decelerated during 2000-2009 when the decadal average was 3%. The rate of exchange rate depreciation decelerated further during 2009-2014, the five-year average annual rate of depreciation being about 2%. Despite this enhanced stability of the exchange rate of Taka against the UD dollar in recent years, the market and the borrowers however still continue to expect the annual exchange rate depreciation of about 3% while making their decisions to go for dollar denominated loans.

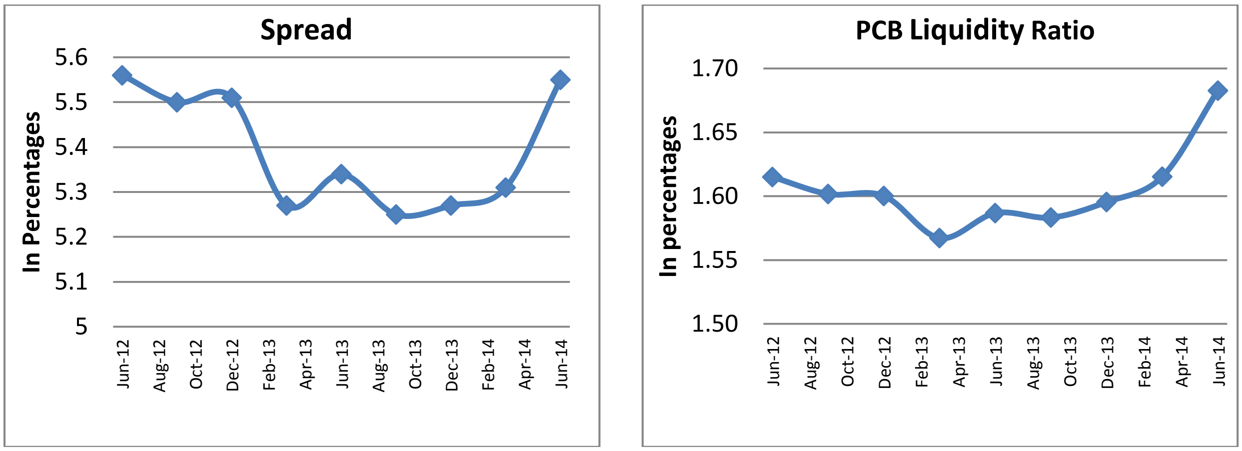
Therefore, considering Libor to be 0.55% and a mark-up of 4.5%, additionally accounting for exchange rate risk factor of about 3%, the cost of borrowing (in taka equivalent terms) from the foreign lenders would be about 8% (Mark-up 4.5%+Libor 0.55%+Expectation with respect to exchange rate depreciation of 3%= cost of borrowing 8%). This rate is still significantly lower than the [12%-14%] charged by the domestic banks to domestic prime borrowers. The main reason behind the exchange rate fluctuations is usually the inflation rate differential between Bangladesh and its major trading partners. As we know it very well, domestic inflation rate in Bangladesh is much higher than the inflation rates of its trading partners. Additionally, if borrowers are concerned about the uncertainties associated with the exchange rate depreciation induced increase in cost of fund, they may hedge their risk in the forward foreign exchange market which would give them additional security.

Lower international borrowing rates should stimulate competition within the domestic banking system

In terms of the domestic private sector credit market, liberalization of access to foreign loans will definitely create pressure on the local banks to reduce their lending rates in order to compete with foreign lenders. Since 2012, there has been a steady decline in private sector growth where private sector credit growth came down to a 13-year low of 11 percent at the end of November 2013 and banks' loan-deposit ratio declined to around 71 percent in December 2013. While this deceleration has been primarily caused by a slowdown in the economy and a lack of investor confidence due to the political instability in the country, the growing presence of foreign lenders has also been a factor.

The rise in foreign loans inflow has put pressure on local banks to cut their lending rates as entrepreneurs are being attracted to the overseas financiers, said official sources. Borrowing from foreign sources at lower interest rates made the entrepreneurs reluctant to take loans at high rates from the country's financial market. It was observed that domestic banks have already started lowering rates with the hope that the trend will continue further. As mentioned above, the domestic lending rates are already on the decline due to the increased competition from foreign lenders. The deposit rate has also declined from 9.04% to 8.13% from June 2012 to June 2014, which indicates an increase in spread. However, this increase in spread may also be explained by the increase in loan loss provisions due to provisioning requirements associated with increased classified loans in the banking system. In particular, the recent series of loan scams and defaults which has left many commercial banks, especially public sector ones, in a precarious position.

Figure 3.10: Interest Rate Spread and PCB Liquidity Ratio of Bangladesh



However, the increase in external borrowings by the private sector has added to the swelling of excess liquidity in the country's banking sector. Bankers said the local banking industry is now sitting idle on surplus liquidity—more than BDT 800 billion—because of non-utilization of funds. The credit growth of the banks was 10.29% in March 2013 with BDT 660 billion in excess liquidity. The growth was 8.97% in June 2013 when the liquidity was BDT 790 billion and 7.40% in September 2013 as the level of excess liquidity rose further to BDT 840 billion. Investment activity has been subdued and there has been a fall in lending rates of banks. The central bank is expected to ensure that the businesses are aware of the exchange rate risks, and that the funds borrowed from abroad are fully utilized as intended, as there have been allegations that a section of borrowers deposit the funds in banks at high deposit rates.

Bangladesh Bank is in a mood to approve foreign loan applications as the policy decision has positive implications on the domestic banking sector such as putting pressure on banks to bring down the lending rates by raising competition. Bankers are now under external pressure to bring down the interest rates on lending due to increased availability of foreign loans. Big entrepreneurs are more interested in taking foreign loans as they can borrow at lower rates which are as low as 6%. However, these entrepreneurs will become interested in taking loans in local currency if the trend of reducing lending rate continues and the interest rate in the international capital market picks with the US economy gaining momentum. Domestic lending rates are likely to also come down further due to continued cut in deposit rates by the commercial banks and falling inflation. Borrowing from foreign sources at lower interest rate will also help reduce interest rate spread in the country's financial market as competition from abroad will push domestic banks for higher efficiency in the banking sector.

8. Recent Setbacks to the Banking Sector: Banking Scams and Default Loans

In three months from March 31, 2014 the total default loans of banks rose to Tk. 3,183 crore with the scam-hit BASIC Bank accounting for almost 64 percent of the rise. As of June 30, the banking sector's total default loans stood at Tk. 51,345 crore, up 6.59 percent from the first quarter, according to Bangladesh Bank data. The amount is 10.75 percent of the total outstanding loans. The state-run BASIC Bank alone accounted for Tk 2,034 crore of the default loans, which was 40.77 percent of its total outstanding loans. Only ICB Islami Bank has a higher percentage of default loans.

Out of the 47 scheduled banks (excluding the nine new banks), 23 banks experienced an increase in their default loans whereas remaining 24 banks experienced a decrease. The default loans of four state-owned commercial banks' increased by Tk. 1,030 crore between the months of April and June, with Agrani Bank alone accounting for Tk. 571 crore of the total amount. The default loans of private commercial banks rose by Tk. 632 crore, with just two banks responsible for 80 percent of the sum. Foreign banks also saw their default loans increase Tk 196 crore.

On the other hand, the default loans of the three specialized banks, Krishi Bank, Rajshahi Krishi Unnayan Bank and Bangladesh Development Bank, declined. Various experts highlighted the special rescheduling facility that was allowed by the Bangladesh Bank especially due to political turbulence last year, as the main reason for the increase in default loans. Many failed to repay the credit later, thus adding to the already huge amount of default loans. What made this worse were many banks extending this credit facility to even their default borrowers to make their balance sheets look better. Later, however, inspections by the Bangladesh Bank detected these irregularities which resulted in loans being classified again.

Another reason behind the increase in default loans was that in 2012 and 2013 many loans were given through fraudulent practices, which are now gradually becoming defaults. Even though political tensions are somewhat stable now, businesses are still recovering and many are unable to repay their loans on time. The carryover of the losses incurred by investors in the stock market with borrowed funds (margin borrowing), which were not classified and provisioned against under special arrangements with Bangladesh Bank, is also adding to the amount of classified loans. Another reason for the rise in default loans of state-owned banks is the bad financial performance of jute sector enterprises, including public sector entities.

Box 3.1: Banking and Other Financial Scams of Bangladesh

In this environment of an unfinished financial sector reform agenda, the recent unfortunate scandals involving the state-owned banks and some nonbank institutions raise considerable concern and anxieties. Serious questions emerged regarding the health of the banking system and the capability/effectiveness of the regulatory regime: First, how the recent scams in the public banks undermined the financial health of the banking sector; Second, adequacy of banking safeguards in Bangladesh; and Finally, appropriateness of the banking oversight arrangements in Bangladesh. Below are some of the major scandals that rocked the financial system in Bangladesh in recent years:

Sonali Bank/ Hallmark Scandal

In May 2012, a report from the Bangladesh Bank revealed that the Ruposhi Bangla Hotel Branch of the state-owned Sonali Bank, Bangladesh's largest commercial bank, illegally disbursed Tk. 36.48 billion (US$460 million) in loans between 2010 and 2012. The largest share, of Tk. 26.86 billion (US$340 million), went to the now infamous Hallmark Group. While the focus has understandably been on Hallmark, other companies also participated in the fraud, including: T and Brothers (Tk. 6.10 billion), Paragon Group (Tk. 1.47 billion), Nakshi Kni, (Tk. 660 million), DN Sports (Tk. 330 million) and Khanjahan Ali (Tk. 50 million). The alleged scam exploited the inland Letter of Credit (LC) system of financing trade. Hallmark is accused of establishing fake companies, such as Anwara Spinning Mills, Max Spinning Mills, Star Spinning Mills, which were shown as recipients of the LCs. These companies submitted falsified paperwork reporting deliveries of fabrics to Hallmark, which were then paid for by the LCs from Sonali Bank's Ruposhi Bangla branch. Because the fictitious companies and Hallmark had their accounts at the Ruposhi Bangla branch, on paper it looked like the branch's assets and liabilities were balanced out. Another financial practice, known as Inland Bill Purchases, was then used to spread some of the bad loans throughout the banking system..Portions of the bad loans were passed on to twenty-seven other banks. One major concern is recovery of the lost money. According to the findings of a parliamentary committee probe, of the Tk. 26.86 billion loaned to Hallmark, only about Tk. 4 billion was actually invested and the remaining amount could not be traced. Sonali Bank now confronts serious financial and leadership challenges. It had to cancel a Tk. 800 million loan due to financial shortfalls, and it has to borrow heavily from other banks to stay afloat.

Irregularities found in BASIC Bank

Another Banking sector scam that has gained a lot of attention is the BASIC Bank's irregularities with its loans. The amount of non-performing loans of the scandal-hit state-owned BASIC Bank now stands at over Tk. 4,157 crore, or 36.55% of the bank's capital. The bank's Gulshan, Dilkusha and Shantinagar branches have disbursed much of the loans violating loan guidelines. In many instances, false papers were used to provide loans. The observation is that the whole management, and the Board of the bank had colluded to grant loans in violation of standard banking practices, and the irregularities continued for 4-5 years.

The Destiny Multipurpose Cooperative Society Ltd (DMSCL) fiasco

The alleged fraudulent activities of the multilevel marketing (MLM) company Destiny 2000 Limited have stirred the whole nation recently. The Department of Cooperatives (DoC) had detected financial irregularities of around Tk. 1,450 crore in the operations of Destiny Multipurpose Cooperative Society Ltd (DMCSL), a sister concern of the controversial Destiny 2000 Group. The irregularities unearthed were-- misuse of funds, unauthorised expenditures and investments, recruitment of members, commission and overvaluation of assets -- through an investigation that took about four months. The non-financial irregularities found by the DoC are: enrolment of fake members and concealment of information about investments in other entities. The DMCSL had only 167 members in 2006-07, but it rose to 0.64 million in 2010-11 and nearly 0.85 million in 2011-12. DoC investigation also found that most of the entities where DMCSL invested exist only in paper.

Losses Incurred by the Banking System in Chittagong: The Bismillah Group and Others

According to a Bangladesh Bank report, Bismillah Group swindled about Tk. 1,100 crore from state-run Janata Bank and four private commercial banks — Prime Bank, Shahjalal Bank, Jamuna Bank and Premier Bank -— showing fake export documents, taking government's cash incentive to open business firms abroad and with accommodated bills through Letters of Credit (LCs). Other business groups in Chittagong also incurred heavy loan losses due to commodity price fluctuations and wrong/speculative investment decisions.

9. Microfinance

The number of Microfinance institutions has grown phenomenally over the years and at present there are 599 such institutions that have been licensed by the Microcredit Regulatory Authority (MRA) to operate Micro Credit Programs. Grameen Bank is out of the jurisdiction of MRA as it operates under a distinct legislation- Grameen Bank Ordinance, 1983. Microcredit programs (MCP) in Bangladesh are implemented by various formal financial institutions (nationalized commercial banks and specialized banks), specialized government organizations and Non-Government Organizations (NGOs). Despite the fact that more than a thousand institutions are operating microcredit programs, only 10 large Microcredit Institutions (MFIs) and Grameen Bank accounts for 87% of the total savings of the sector and 81% of total outstanding loans of the sector. Details of MFI development over the past few years are given below.

Table 3.9: Indicators of Microfinance Institutions

	June-09	June-10	June-11	June-12	June-13
No. of Licensed NGO-MFIs	421	518	580	618	694
No. of Employees	1,07,175	1,09,597	1,33,828	1,30,654	1,32,734
No. of clients (Million)	25.	25.	35.	33.	33
No. of Borrowers (Million)	19.	19.	29.	28.	28
Amount of Loan Outstanding (TK Billion)	143.	145.	246.	291.	341
Amount of Savings (TK Billion)	51.	51.	122.	192.	226.2

Source: Microfinance Regulatory Authority, Bangladesh

Despite impressive growth in recent decades, in terms of relative size microcredit institutions account for only 7.5% of the banking system assets, and its client base also seem to have already peaked at about 33 million. The volume of lending is still growing at a relatively healthy pace supported by growth in mobilization of savings and larger loan size. However, many MFIs are now looking at financing small enterprises to sustain their business with larger amounts of loans per person/enterprise.

10. Financial Inclusiveness: The Growing Importance of Branchless Banking

One of the main prerequisites for achieving growth and making the growth inclusive in nature is enhanced access to finance. Financial systems serve a very important purpose in providing financial access, offering a wide range of financial services from savings to credit and even risk management products. The poor and the vulnerable groups are most likely to benefit from inclusive financial systems which have limited or no price or non-price barriers. Without such financial inclusion, the poor are mostly dependent on their own limited savings and earning to invest.

Commercial Banks are traditionally considered to be the first option for providing a wide range of financial services. However, commercial banks fail to cater the credit needs of poor people due to perceived high risk and high transaction costs associated with small loans and saving deposits. In addition, travelling to and queuing at distant branches of banks might also mean forgoing their daily wages as bank branches can be located quite far away. There is also an absence of better serviced credit, savings, payments, insurance (safety net/ micro insurances) etc. Government has tried to improve inclusion through policies, regulations, and even direct intervention and subsidies (e.g. The Taka 10 bank account effort by Bangladesh Bank, discount lending facilities for SMEs, interest rate ceilings on micro credit etc.). Subsidies are inherently inefficient solutions and for regular commercial banks Taka 10 bank accounts cannot be a sustainable venture. MFIs have been able to fill that gap to a certain extent. Under this arrangement, small amounts of credit are disbursed to the very poor people who have no access to formal financial institutions. Given the remote areas that lack basic infrastructure that these microfinance institutions cater to, delivery of loans can be difficult not to mention costly. Branchless banking channel using mobile phones could be far more preferable to poor people for receiving micro loan payments.

Bangladesh Bank has advocated for mobile operators and MFIs to be active partners. It has provided 10 licenses to banks to offer the full range of mobile financial services and this regulatory certainty has set the market in motion. Mobile phone companies now have technology and networks that reaches some of the most remote parts of the country, and with a big part of the population having access to cell phones; it is much more feasible for them to make their transactions through thousands of retail outlets like local village shops.

By late 2011 and into 2012 two early leaders have emerged with the largest customer bases and agent networks, The bKash service and Dutch Bangla Mobile. The bKash service is provided by BRAC Bank in cooperation with its subsidiary bKash. And Dutch Bangla Mobile is a service from Dutch Bangla Bank. Combined, these two providers made the largest contribution to the nearly 500,000 new mobile accounts and more than 9,000 new agents. Such services are also provided by others like Trust Bank Ltd., Bank Asia, UCash service from United Commercial Bank Ltd., MyCash from Mercantile Bank Limited and the Fast Cash service from E-Cash Ltd.

Bangladesh’s first complete mobile financial service provider, bKash Limited, a BRAC Bank subsidiary, launched its mobile banking operation in July 2011. bKash is designed to provide financial services via mobile phones to both the unbanked and the banked people of Bangladesh. The overall bKash value proposition is simple: a safe, convenient place to store money; a safe, easy way to make payments and money transfers. The bKash mobile wallet is a VISA technology platform, which is fully encrypted to ensure most secure transactions. The mobile wallet is essentially the customer account into which money can be deposited and out of which money can be withdrawn or used for various services. Customers will be able to receive electronic money into their bKash accounts through salary, loan, domestic remittance, and other disbursements and eventually will cash out the electronic money from bKash authorized agents/ATM. There are several cons of bKash, the service is not available everywhere in Bangladesh. There are four mobile operators in Bangladesh but till now all the mobile operators are not covered by bKash. The existence of bank account is totally forbidden in the bKash system.

Dutch-Bangla Bank Limited (DBBL) is the first bank in Bangladesh, which introduced mobile banking service to bring poor people from remote area under smart banking service. DBBL is operating this new innovative banking service through Banglalink and Citycell mobile operators and their approved agents throughout the country. One can create a bank account visiting any of the approved agents showing proper documents with a fee of Tk. 10. Subscriber must own a mobile phone to get the service. Once the account is created, a 4 digit mobile banking PIN code will be provided to perform all sort of banking activities securely and secretly. Subscriber can withdraw and deposit cash amount from his mobile going to the agents and agents will guide and help the customers if there is any difficulty. Since, mobile network is extremely insecure and data are sent unencrypted, in the case of Bkash, a customer can deposit five times a day or withdraw money three times a day and he can deposit or draw upto Tk. 25,000 per day from agent and Tk 20000 per day from an ATM. In case of cash out the charge will be 2 percent of the transaction amount whereas for cash-in there are no charges. However, the registration fee, salary and remittance disbursement services will be provided free of cost.

The mobile financial services market is at an early stage of development as providers are working to improve their technology, build agent networks and acquire new customers. This involves finding and training agents, marketing, helping customers transact and acquiring customers by using know-your-customer (KYC) and account opening processes. A survey conducted by Bangladesh Bank found that the new services are reaching multiple parts of Bangladesh and that most clients and agents express cautious optimism about mobile financial services being valuable to them. Three quarters of clients said their main reason to use this service is to send or receive payments, while the remaining one-quarter highlighted safekeeping as the main reason. Rural users specifically mentioned the benefits of receiving payments. It can be observed from Table 3.10 that value and volume of mobile money transactions have grown phenomenally in the last couple of years explaining the growth in the number of agent outlets and mobile money accounts.

Table 3.10: Indicators of Mobile Banking for Bangladesh (2011-2013)

Indicators	2011	2012	2013
Number of registered mobile money accounts	125,506	3,229,573	13,173,425
Number of active mobile money accounts	7,186	989,128	4,472,342
Number of registered agent outlets	5,654	54,594	185,023
Number of active agent outlets	2,551	45,183	136,333
Number of mobile money transactions (during the reference year)	229,592	25,895,678	228,601,768
Value of mobile money transactions (during the reference year) in Million Taka	476	63,809	516,648
Outstanding balances on active mobile money accounts in Million Taka	44	746	3,141

Source: Financial Access Survey, IMF

11. Challenges and Concerns Relating to the Banking Sector

Although the banking sector has had its share of success, there are a number of serious concerns that remain and are likely to intensifying if remained unattended.

First, there are sharp differences in the performance of banks, especially between private and public banks. For example, the NPL of private banks in June 2014 was 5.7%, but it was 23% for public commercial banks and 33% for public specialized development banks. Furthermore, the reported NPL numbers likely understate the true portfolio quality problems in the public and private banks because they do not fully account for the effects of the recently discovered scams, the losses incurred by the merchant banks due to the bursting of the stock price bubble, the quality of regulatory standards are not as stringent as they should be, and the quality of accounting standards are also not up to the mark.

Second, the definition of NPLs used in Bangladesh was not in line with the international norms. The standard international definition for NPLs was scheduled for adoption from July 2012. This move has, as expected, contributed to the deterioration of the NPL ratios beginning 2013. At the same time, the accounting standards followed in measuring and weighting of capital, assets and risks in the public banks are not fully consistent with BASEL II definition. It is therefore likely that the true NPL of the banking sector is under-stated while the capital adequacy is over-stated.

Third, there are important issues relating to the corporate governance of banks. Due to political connections and influences some private banks are able to bypass standards relating to fit and proper criteria for bank board and management. Importantly, public banks are not within the purview of the supervision of the Bangladesh Bank. As such, there are serious concerns about the quality of the board and top management of these banks. Furthermore, their compliance with prudential regulations is weak.

Fourth, the capacity and flexibility of Bangladesh Bank to supervise the banking industry and implement prudential measures are often constrained. Owing to lack of autonomy, Bangladesh Bank often cannot withstand political pressure that compromises prudential management. Similarly its operational flexibility is inadequate. For example, it does not have wage setting flexibility and as such cannot hire quality staff. As a result, quality of bank supervision suffers in many ways such as banks sometimes bypassing the prudential standards for liquidity ratios, compliance with credit/deposit ratios, exposure to stock markets, compliance with capital adequacy and accounting standards.

Fifth, there is widespread allegation from the business community that bank interest rates and charges in Bangladesh are too high. These high interest rates have adversely impacted investment and domestic economic activity. This however is an important economic policy issue at the national level and will require careful review of many related aspects of Bangladesh economy before making an informed policy decision in this regard.

Sixth, the experience of the past few years has shown that the lack of autonomy of the Central Bank is particularly constraining in regards to the conduct of sound monetary policy and the granting of licenses for new banks. Monetary policy was overtly expansive during FY10-12 partly owing to pressures from the Government to pump liquidity in the stock market and the financing of Treasury operations. This led to considerable damage to underlying economic outcomes including the fueling of inflation, contributing to asset price bubble and putting pressure on the exchange market during those years. Similarly, undue Government pressure has forced Bangladesh Bank to issue several new licenses to new private banks at a time when most analysts believe new banks were not needed as they would tend to substitute the services provided by existing banks and contribute to solvency and/or profitability problems for existing banks.

Finally, corrective monetary policy actions over the past 15 months or so have tended to offset some of these adverse effects, particularly in the areas of inflation and exchange market stability. Also, in the area of new bank licenses, the Bangladesh Bank management approached this political challenge as professionally as possible by laying down more strict performance criteria than in the past for the selection of the new banks. Yet, these experiences are illustrative of the risks of political interventions in the conduct of the functions of the Central Bank that must be averted to establish a healthy banking system.

ii) Non- Banking Financial Institutions (NBFIs)

Non-Bank Financial Institutions (NBFIs), in addition to banks, are also important financial intermediaries in the Bangladesh economy. They are playing a crucial role in the financial sector by providing additional financial services that are not always provided by the full-fledged banking industry. NBFIs have achieved impressive growth in recent years, reflecting the process of financial innovation and holding the promise of deepening financial intermediation in long-term financing needs. The financial institutions, with more multifaceted products and services, have taken their place in the competitive financial market to satisfy the changing demands of customers, adding differentiation to the bank-based financial market of Bangladesh. NBFIs also play a hefty role in the capital market as well as in real estate sector of Bangladesh. Like the banks, most of the NBFIs have separate subsidiaries to operate merchant banking activities. NBFIs are supervised by Bangladesh Bank in a risk-based supervisory system that reflects their important contributions.

1. Historical Background

NBFIs were incorporated in Bangladesh under the then Companies Act, 1913 and were being regulated by the provisions contained in Chapter V of the Bangladesh Bank Order, 1972. Later, to remove the regulatory deficiency and also to define a wide range of activities to be covered by NBFIs, a new statute titled the 'Financial Institution Act, 1993' was enacted in 1993, followed by the 'Financial Institution Regulation, 1994'. NBFIs have been given licenses and are egulated under the Financial Institution Act, 1993. As per the Financial Institution Regulation, 1994, at present, the minimum paid up capital for NBFIs is Taka 1.0 billion. So far 21 NBFIs have raised capital through issuing IPOs, while three are exempted from the issuance of IPOs. Other major sources of funds of NBFIs are term deposits, credit facilities from banks and other NBFIs, the call money market, as well as bonds and securitizations.

The NBFIs' business line is narrow in comparison with banks in Bangladesh, but they are offering some products to a greater extent than banks. NBFIs are working as multi- product financial institutions. Although the major business of most of the NBFIs is lease financing, still a handful number of NBFIs are involved in different financing activities, namely, term lending, house financing, merchant banking, equity financing, venture capital financing, project financing, financing to pilgrimage, etc. NBFIs also extend services to various sectors like textile, agriculture, small and cottage, chemicals, trading, pharmaceuticals, transport, food and beverage, leather products, and construction and engineering.

2. Performance, Regulation and Supervision of NBFIs

There are currently 29 Non Banking Financial Institutions (NBFIs) out of which, one is owned by the government,15 are privately owned local initiatives and 13 were initiated by joint venture initiatives with foreign participation. Major sources of funds of NBFIs are Term Deposits of various durations (at least six months or more), Credit Facility from commercial banks and other FIs, access to Call Money market as well as Bond and Securitization. The asset base of (NBFIs) is relatively small compared to that of banking sector. The NBFIs comprised of 4.8 % of the total assets of the Money Market assets as of June 2013.

Table 3.11: Assets, liabilities and deposits of Non-Banking Financial Institutions (NBFIs) (in billion Taka)

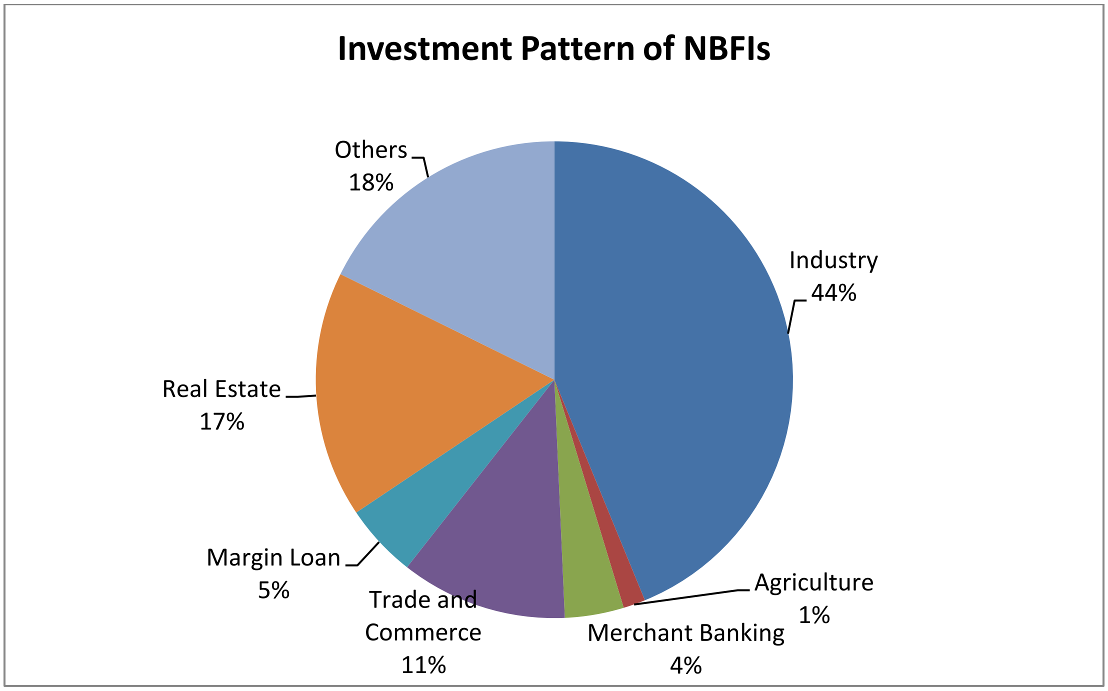
	June 2013
Total Assets	378.5
Total Liabilities	316.3
Total Deposits	174.0

Source: Bangladesh Bank

Assets: The asset base increased substantially in FY13. Aggregate industry assets stood at Tk. 333.9 billion in 2012 from Tk. 288.4 billion in 2011, showing a higher growth of 15.8 percent compared to the previous year. At the end of June 2013, assets stood at Tk. 378.5 billion.

Investment: NBFIs are investing in different sectors of the economy, but their investments are mostly concentrated in the industrial sector. In June 2013, NBFIs investment in different sectors included industry (43.8 percent), real estate (16.7 percent), margin loans (5.0 percent), trade and commerce (11.3 percent), merchant banking (4.0 percent), agriculture (1.5 percent) and others (17.7 percent) given in Figure 3.11.

Figure 3.11: Investment Pattern of NBFIs in June 2013



Source: Bangladesh Bank

As compared with December 2012, investment in industry increased by 6.2 percentage points due to a significant rise in investment in power, gas, water and sanitary services. Other investments showed little changes, except housing which decreased by 2.6 percentage points at the end of June 2013. NBFIs are allowed to invest in the capital market to the extent indicated in the Financial Institutions Act, 1993.

Deposits: Total deposits of the NBFIs in 2012 rose to Tk. 145.4 billion (53.0 percent of total liabilities) from Tk. 112.6 billion (47.8 percent of total liabilities) in 2011, an overall increase of 29.1 percent. Total deposits further increased to Taka 174.0 billion at the end of June 2013.

Other Liabilities: The aggregate liabilities of the industry in 2012 increased to Taka 274.3 billion from Taka 235.7 billion in 2011, while equity increased to Taka 59.6 billion in 2012 compared with Taka 52.7 billion in 2011, showing overall increases of 16.4 percent and 13.1 percent respectively. In June 2013, total liabilities stood at Taka 316.3 billion and equity reached at Taka 62.2 billion.

Rating of NBFIs: the performance of this sector is evaluated through the CAMELS rating which involves analysis and evaluation of the six crucial dimensions of NBFIs' operations. The six indicators used in the rating system are (i) capital adequacy; (ii) asset quality; (iii) management efficiency; (iv) earnings; (v) liquidity; and (vi) sensitivity to market. Basel-II has been implemented in the NBFIs from January 1, 2012. BB has issued a guideline, Prudential Guidelines on Capital Adequacy and Market Discipline (CAMD), to promote international best practices and to make the capital of NBFIs more risk-based as well as more shock-resilient. The instructions regarding minimum capital requirements, supervisory review process, and disclosure requirement as stated in the CAMD guidelines have to be followed by all the NBFIs as statutory compliance. As a part of the consultative approach in this regard, a high level Steering Committee (SC) headed by a Deputy Governor of BB has been formed, comprising NBFIs' chief executive officers, for working on policy decisions. Furthermore, there is a Working Group (WG) headed by an Executive Director of BB to assist the SC in decision-making. A Basel Implementation Cell (BIC) under DFIM has been formed to assist and carry out the instructions of SC and WG on the Basel accord implementation.

Earnings and profitability: Earnings and profitability of a NBFI reflect its efficiency in managing resources and its long term sustainability. These indicators determine the capacity to absorb probable losses by building an adequate capital base, finance its expansion, and pay adequate dividends to its shareholders. Among various measures of earnings and profitability, the best and widely used indicator is Return on Assets (ROA) which is supplemented by Return on Equity (ROE). ROA and ROE of all the NBFIs in December 2012 were 1.9 and 10.4 percent, respectively. As of December 2012, out of 29 NBFIs, 2 are rated as "1 or Strong", 11 are rated as "2 or Satisfactory", 13 NBFIs are rated as "3 or Fair", and 3 are rated as “4 or Marginal" in the earnings and profitability component of the CAMELS rating matrix.

iii) An Agenda for the Money Market

1. Recommendations for the Reform of the Banking Sector

At the very top of the reform list is the need for autonomy of the Bangladesh Bank. The Government should carefully review the issue of the independence of the Bangladesh Bank and the amount of autonomy it wants to convey to the regulator. A fully autonomous regulator that can hire quality staff it needs, procure the technology it requires to strengthen its effectiveness, and implement prudential norms without the fear of political influence is essential to prevent the Hallmark and Basic bank type scams in the future. An autonomous Central Bank is also necessary to conduct sound monetary policy management and to exercise utmost prudence in such matters as the licensing of new banks and the use of directed credits. Recent experience with government interventions in these matters is illustrative of the critical importance of establishing an autonomous Central Bank in Bangladesh.

The Government should also rethink the strategy for the supervision of public banks. The weakly performing public banks with a huge amount of infected portfolio are a serious threat to the soundness of the banking sector. In addition to efforts to improve their performance, these banks must be brought fully under the regulatory supervision of Bangladesh Bank and must be required to comply with all prudential norms, including certification of the bank boards and senior management as per the approved fit and proper criteria. The Government must understand that it cannot both be a producer of banking services (as owner) and also a regulator of these services. This is a serious conflict of interest that must be corrected.

Over the longer term, the Government should also reassess whether it really needs be in the business of providing banking services. There is plenty of international evidence that publicly owned banks do not perform well in an environment of weak governance. The quality of portfolio inevitably gets tainted owing to political interventions that are inconsistent with sound banking decisions. The first best option is to privatize the state-owned banks. Unfortunately, this is not a politically palatable option in Bangladesh. There are also other practical problems including union pressure against privatization and, additionally, finding sound buyers who are untainted by political favors is a major challenge.

In a political environment where privatization is not imminent, there is a second-best approach that might work. Public banks tend to have an unfair advantage in mobilizing deposits because of the perception of state guarantees and de-facto immunity from effective supervision. Because of these concessions, state-owned banks are able to stay float even with very poor loan portfolios. The adverse implications of these improper privileges for efficient lending decisions could be tackled by taking away the lending functions of these banks. If such banks are allowed to only hold government paper, their deposit growth would be indirectly limited and sounder banks would intermediate more flows. Importantly, the deposits mobilized will be safe and not exposed to risks of the type presented by the recent Sonali Bank scam.

Such lending restrictions are akin to a "dual banking system" with "narrow banks" that are likely to remain state-owned (and only allowed to gather deposits to invest in government paper) and conventional private sector banks. No new laws are required because the government as owners of the public banks could take this decision. The idea of narrow bank is not a new one and merits serious attention[2]. At the least the Government might ask Bangladesh Bank to review this option carefully and provide a technical proposal. The Government must understand that it faces a very tight fiscal situation owing to the burden of energy subsidies and it cannot absorb yet another fiscal shock from a potential liquidity crisis in public banks emerging from an overload of infected portfolio. The government has already spent or allocated Tk. 95 billion during FY14 and FY15 for recapitalization of public sector banks and much more resources wil be needed in the coming years only to fill the huge wholes already identified or created (buy yet to be publicly identified) in the balance sheet of public banks.

Bangladesh Bank is facing a challenge in balancing its exchange rate policy with its monetary policy and inflation targets. In the last two years Bangladesh Bank has been successful in maintaining the exchange rate stability (virtually at an unchanged level) in nominal terms against the US dollar. But in doing so it had to buy foreign exchange in the interbank market contributing to a large increase in the net foreign assets (NFA) and liquidity expansion. In order to mop up the excess liquidity from the banking system it had to issue Bangladesh Bank bills with consequent loss of income. While this policy has prevented an appreciation of the Taka against the dollar in nominal terms, because of the inflation differential against its trading partners the Taka exchange has indeed appreciated significantly in real effective term (REER). While this policy may work in the short term, continuation of this policy—leading to massive appreciation of Taka in real effective terms--over the medium term would not be sustainable.

Bangladesh is also facing strong demand from the private sector for reducing interest rates on domestic lending, especially to boost domestic investment by the private sector. However, as discussed earlier, the reduction of interest rates should be on the basis of a medium term market based process that involves reducing inflation, reducing the cost of doing banking operations, and lowering loan loss provision. Therefore, any lowering of interest rates on an ad hoc basis and administratively will not work to reduce the interest rates in a sustainable manner. Systematic efforts to reduce the loan losses and required provisioning, continued lowering of domestic inflation, and related adoption of prudent monetary policy and enforcement of strengthened supervision would need to be taken by Bangladesh Bank under a market-based strategy in order to reduce interest rates.

Along with financial deepening, Bangladesh is also experiencing deepening of financial inclusion. Efforts by Bangladesh Bank to make inward remittances at reduced costs and much

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2 A more detailed analysis of the idea of narrow banks as a serious policy option is contained in Sadiq Ahmed, Marilou Uy and S. Ramachandaran (2003). "South Asian Banking and Finance: Growth with Festering Problems" South Asia Region Internal Discussion Paper IDP-186, The World Bank: Washington D.C.

speedier transfers have encouraged more people to remit money through the formal channel and away from the informal hundi system. Bangladesh Banks efforts to allow farmers and sharecroppers to open bank accounts at Tk. 10 only has also increased small account holders to be part of the formal banking system. Micro credit institutions have also contributed to enhance inclusive financial deepening in recent decades. More recently, mobile banking and money transfers through mobile phones have taken Bangladesh's financial inclusion to a different level. However, there are some regulatory issues that need to be addressed for sustained growth of mobile banking activity in a more participatory manner in the coming years.

Regarding the implications for the adequacy of banking safeguards, there are two inter-related issues. First is the adequacy of internal controls within the Sonali Bank and other public banks. And second is the adequacy of the supervisory efforts of Bangladesh Bank. The transfer of taka 36 billion from a small Sonali Bank branch is a mind-boggling event. Sonali Bank Board and the Managing Director both denied having any knowledge of these transactions. If this is really true, it raises huge concerns about the lack of internal controls. There is an urgent need for Bangladesh Bank to do a full review of the internal control mechanisms of all the public banks and ensure that all loopholes including those related to transactions recording, accounting standards and approval mechanisms are immediately secured. Regarding the supervision arrangements in the Bangladesh Bank, the immediate question is how did this scam of such magnitude prevail for so long without detection in the supervision reports of the regulator? There could be many possible reasons. Whatever they may be, the event does indicate a serious gap in the supervision arrangement that must be carefully reviewed and quickly rectified.

The recent performance of state owned banks, therefore, calls for a fundamental change change in the manner the state-owned banks operate in Bangladesh. Since the government is opposed to privatization of the state-owned banks and management of these banks are not likely to improve significantly as has been demonstrated time and again over the last 45 years, their activities should only be limited to "narrow banking" which allows state-owned banks to gather deposits but limit their direct lending only to the government and to public enterprises against government guarantee. Any surplus fund of the SCBs can be placed in the interbank market for on-lending by the private banks.

There has been a proliferation of branch network by the SCBs and specialized Agricultural Credit banks without regard to commercial opportunities. Such branch expansion has also contributed to manpower expansion and a rapid increase in overhead costs of the SCBs and Specialized public banks. Since commercial activities of these public banks can easily be covered by private banks and in line with the long-term strategy to speedily reduce the market share of publicly owned banks, expansion of branch and other operations of public banks should be strictly limited.

The Destiny 2000 scam has shed light on the poorly understood practice of Multilevel Marketing (MLM) and has posed serious questions regarding how a possible scam of this extent could be sustained for so long. Inadequate understanding on the part of investors, lack of social awareness, corruption, a weak regulatory framework and even weaker implementation are mainly to be blamed for this debacle. These scandals, although has no financial bearing on the banking system directly, it entailed an huge amount of financial loss for the citizens and therefore hurts private sector confidence. Under the initial practice of MLM, which was operated under antiquated British laws, lending activities are completely unregulated. Many more scandals like this have already surfaced and more might be coming. With hundreds of billions of Taka in investment and the fates of millions of household investors at stake, the effects of the problem dig deep into Bangladeshi society. The impact of the unfortunate and despicable Sonali Bank scandal on the financial health of the banking sector depends upon the strength of the Government's response to this case. If the Government responds swiftly and in accordance with the law of the country with no-holds-barred, then Bangladesh should be able to ride over the problem with manageable damage. But if the response is weak and uncertain, as it appears to be the case at the moment, the potential long-term downside risk to the health of the financial sector is huge.

The gazette notification on Multi Level Marketing Activities (Control) Ordinance -2013 was published in September 2013 after the cabinet approved the draft of the Multi level Marketing Activities (Control) Act, 2013 in August 2013. The ordinance has the provision to protect the interest of the consumers, distributors and other stakeholders involved with Multi Level Marketing (MLM) business and bring the companies under a legal framework. It has a provision of maximum 10 years and minimum 5 years' jail for running MLM business without license from an appropriate authority. The license could not be transferred without prior permission of the government, and the government could cancel the license for violation of conditions or impose penalties. However, effective enforcement of this law will continue to be a major challenge for the regulator.

2. Policy Lessons for Foreign Denominated Borrowing

Borrowing from external sources by the private sector is still a relatively new concept for Bangladesh and its success in the past three years in terms of increase in gross lending has been encouraging. However, as the comparison with neighbors India and leading East Asian economies and China indicates, Bangladesh still has a long way to go. The recent performance of loan disbursement shows that most borrowing companies are still learning ways to manage their loans and the comparatively strict conditions that they must adhere to in order to continue to enjoy this facility. This would certainly bring forth more discipline on the borrowers' part and may lead to development of healthier business practices. A number of policy implications have surfaced from the analysis provided earlier, which are discussed below:

i) Bangladesh is on the path to achieve greater liberalization in terms of foreign borrowing, following the direction of many of its regional counterparts. However, bulk of the foreign lending market is still captured by foreign banks, while the domestic banks lag behind. The main reason behind this is their capital adequacy and balance sheet weakness which do not allow them to actively solicit foreign loans. The domestic banks must rise to the occasion and take necessary steps to enter and actively participate in this market if this virtual monopoly of foreign banks in this growing market segment is to be challenged.

ii) Bangladesh Bank has to vigilantly monitor the foreign loans and loan portfolio to ensure that the county's reserves are not threatened by excessive foreign borrowing. As has been experienced by countries like India and many Asian economies prior to the Asian economic crisis of mid-1990s, excessive foreign borrowing by the private sector, if left unmonitored, may lead to increased country risk assessment by foreign lenders and consequent withdrawal of funds leading to accentuation of BOP pressures, which also harmed the financial sector badly. While continuing with the process of gradual opening of capital account and greater integration with the global financial system, Bangladesh must avoid excessive exposure and imbalanced maturity structure for such loans.

iii) When facilitating foreign borrowing, the local banks need not worry about exchange rate risks as they can always encourage their clients to hedge them. This way the banks are safe and would not need to increase its portfolio risk, while the clients are also hedging their risks. If the clients require lower risk on their loans, the banks can convince/encourage them to incur the additional cost of hedging for exchange rate fluctuations which would in turn also safeguard their own interests.

3. Recommendations for MFIs to move forward

Over the past few decades microfinance institutions have advanced leaps and bounds to invigorate grass root economic development through microcredit. As of recent years however, MFIs have reached a plateau in their in terms of outreach across the country. For expansion, MFIs now need to focus less on the number of beneficiaries and more on the size of loans provided to beneficiaries. Higher loan sizes will eventually lead to businesses of larger scales—from micro to small and medium enterprises. Accordingly, MFIs now need to look towards the transition from micro credit to small credit in order to boost the size of impact. There will also be market consolidation in the process. Number of non-registered MFIs, who are essentially outside the supervision Micro Credit Regulatory Authority (MRA), is sizable and many of them will disappear over time or move to other businesses. Even the registered MFIs will also decline over time through competitive pressure and if the regulatory governance requirements are strictly enforced.

4. Recommendations for NBFIs[3]

Recommendations regarding the development of NBFIs have been made in various studies, Ahmed and Chowdhury (2007), Datta (2014) and Financial Stability Report of Bangladesh Bank (2014), some of which are listed as follows:

i) At present, there is no deposit insurance coverage for the depositors of NBFIs and it is recommended that the NBFI depositors be brought under the umbrella of insurance coverage. The deposit insurance system should aim at minimizing the risk of loss of depositors' funds with NBFIs.

ii) A more Investment friendly policy of Bangladesh Bank for NBFIs, more coordination with Bank financial institution, easy and simplified procedures of reporting to Bangladesh Bank etc. will help in the growth of NBFIs.

iii) The NBFIs need to streamline their loan disbursement methods with focus on low risk industrial segments and adopt better monitoring mechanisms in order to reduce risks associated with their assets.

iv) NBFIs are permitted to undertake a wide array of activities and should therefore not confine themselves to a limited number of products only. Diversifying the product range is a strategic challenge for NBFIs in order to become competitive in the rapidly growing market.

v) Leasing, no doubt, presents a good alternative form of term financing. Even in leasing, investments were not always made in the real sector and non-conventional manufacturing sector. New industrial units were hardly brought under the purview of leasing facilities. This implies that the new customer base has not been created and the growth of industrial entrepreneurship could not be facilitated through NBFI financing packages.

vi) NBFIs may consider initiating the concept of operating lease, instead of the prevalent mode of finance lease, in case of recovered assets to create a demand for second hand or used machinery and equipment.

vii) Active participation of merchant banks is essential to accelerate the capital market activities which can expedite the economic growth of the country. The success of merchant banking operations is largely linked to the development of the security market. So NBFIs should concentrate more on their opportunities in the capital market.

[3] Ahmed, M. N. and Chowdhury, M.I. (2007). Non-Bank Financial Institutions in Bangladesh: An Analytical Review, Working Paper Series- WP 0709, March 2007, Policy Analysis Unit, Bangladesh Bank : Dhaka.

viii) As the tax treatment is totally different in leasing business, mixing up of lending and leasing in the same business portfolio might create the possibility of tax evasion. It is advisable that the two different operations are not mixed, otherwise, it might distort the basic financial norms.

ix) Banks wishing to enter in the leasing business, which is essentially a core operation of NBFIs, should do so through opening subsidiaries so that a level playing field for NBFIs can be maintained. This is needed as banks have access to lower cost funds which allows them to enjoy an advantageous situation compared to NBFIs.

x) An integrated products and services management system can strengthen the role of FIs in developing, redesigning, offering and marketing of existing as well as new financial products and services in more prudent way.

xi) Clientele protection can be enhanced by ensuring the availability of information, proper understanding, and regular feedback.

IV. CAPITAL MARKET

In last two decades, capital market witnessed a number of institutional and regulatory advancements which have resulted diversified capital market intermediaries. At present, capital market institutions and intermediaries are of following types: Stock Exchanges, Stock Dealer/Sock Brokers, Merchant Bankers and Portfolio Managers, Asset Management Companies, Credit Rating Companies, Trustees/Custodians and the Investment Corporation of Bangladesh (ICB). The primary segment of capital market is operated through private and public offering of equity and bond instruments. The secondary segment of capital market is institutionalized by two stock exchanges--Dhaka Stock Exchange and Chittagong Stock Exchange. The instruments in these exchanges are equity securities (shares), debentures, corporate bonds and treasury bonds. The capital market in Bangladesh is regulated by the Securities Exchange Commission (SEC) of Bangladesh.

It has been observed that in recent years the capital market in Bangladesh has grown much faster than the other segments of the financial market. This growth in the capital market was initially (during 2007-2009) fueled by stronger economic fundamentals compared to valuation of stocks. Afterwards, speculative forces had taken various key market indicators like the market capitalization, price earnings ratio and market turnover to unprecedented levels. Table 4.1 shows some selected indicators of capital market developments referring to three choice of years, year 2007 representing the pre-bubble era, year 2010 representing the peak bubble year and finally

2014 showing the current year scenario. It can be observed that market capitalization and the DSE General price index increased dramatically in the peak year.

Table 4.1: Indicators of Capital Market Developments (DSE)

	FY 2007 (Pre-bubble year)	FY 2010 (Peak of the bubble)	FY 2014* (as of June 2014)
Number of listed securities	281	279	315
Issued equity and debt (billion Tk)	83.7	213.1	482.7
Market capitalization (billion Tk)	412.2	2277.0	2386.8
Turnover (billion Tk)	164.7	2714.3	1125.4
General Price Index	2149.3	6153.7	n/a
DSE Broad Index	n/a	n/a	4480
DSE -30 Index	n/a	n/a	1644.8

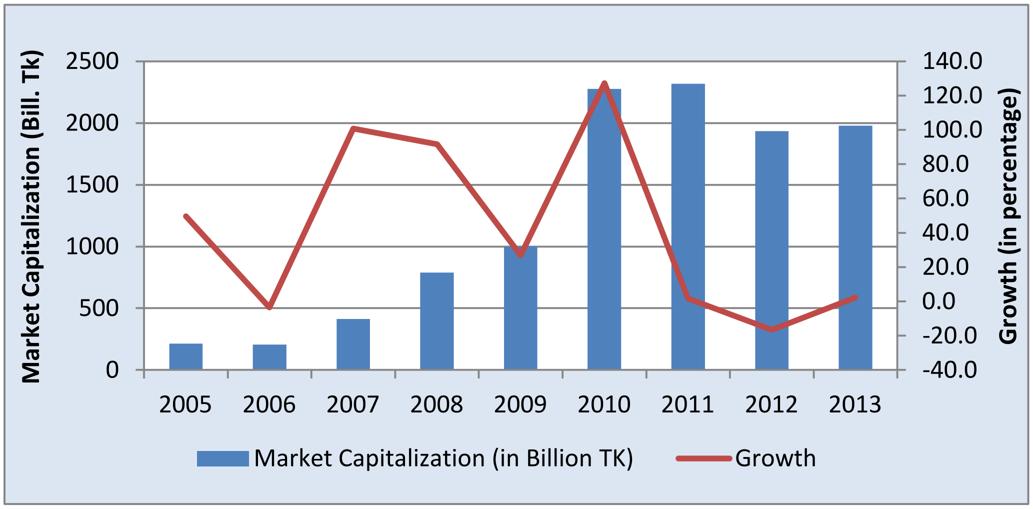
Source: Bangladesh Bank.

This development also negatively impacted on investments in other segments of the financial market i.e. money market and investment in NSD saving instruments by diverting funds from those markets. During the periods of boom in the stock market, the rates of interest on bank deposits and NSD saving instruments were fixed at levels below market expectations, which played an important role in diverting investment funds to the stock market. Diversion of investment funds to the capital market led to over-valuation of stocks and excessive growth in the market capitalization of the securities listed in both Dhaka and Chittagong stock exchanges. As expected, the stock price indices tumbled in 2011 with the bursting of the stock price bubble as the flow of funds to the stock market eventually dried up.

Figure 4.1: Market Capitalization and the DSE GEN Index

Source: Bangladesh Bank, DSE

Figure 4.2: Market Capitalization and its Growth Over the Period 2005-2013



Source: Bangladesh Bank

1. Historical Background of the Capital Market

Although Bangladesh capital market came into existence in early 1950, for the next 40 years it failed to generate much activity. All key market indicators like the number of companies traded in the capital market, market turnover and market capitalization in relations to GDP remained very low relative to its regional comparators. Market regulations and its governing structure were not up-to-date and the regulatory environment was very weak. This weak governance and institutional structure contributed to the formation of first speculative bubble and subsequent burst in 1996. The speculative bubble and burst episode hurt the stock market activity for a long time but led to some operational improvements such as: the Dhaka Stock Exchange (DSE) started trading on computers in August 1998; the Central Depository Bangladesh Limited (CDBL) was incorporated as a public limited company in August 2000 to operate and maintain the Central Depository System (CDS); the CDS was incorporated as an independent company in January 2004.

2. Developments in the Stock Markets

Currently the stock market comprises of two stock exchange companies--Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE). These two stock exchanges are regulated by the Securities and Exchange Commission (SEC). Subsequent to these reforms, the capital market flourished noticeably due to stronger economic fundamentals of the listed companies, various measures by its regulator SEC and opportunity of gaining more returns from holding stocks. Both market capitalization of all shares listed in DSE and its share in total assets of the financial sector increased remarkably. In 2003, stock market capitalization accounted for only 4% of the total assets of the financial system, which increased sharply to 24.7% by 2011 despite a major downward market correction in 2011. Market Capitalization as a percentage of GDP experienced the biggest jump from 16% in 2009 to 33% in 2010. It however declined sharply after 2010.

Figure 4.3: Market Capitalization as Percentage of GDP

Source: Bangladesh Bank; BBS

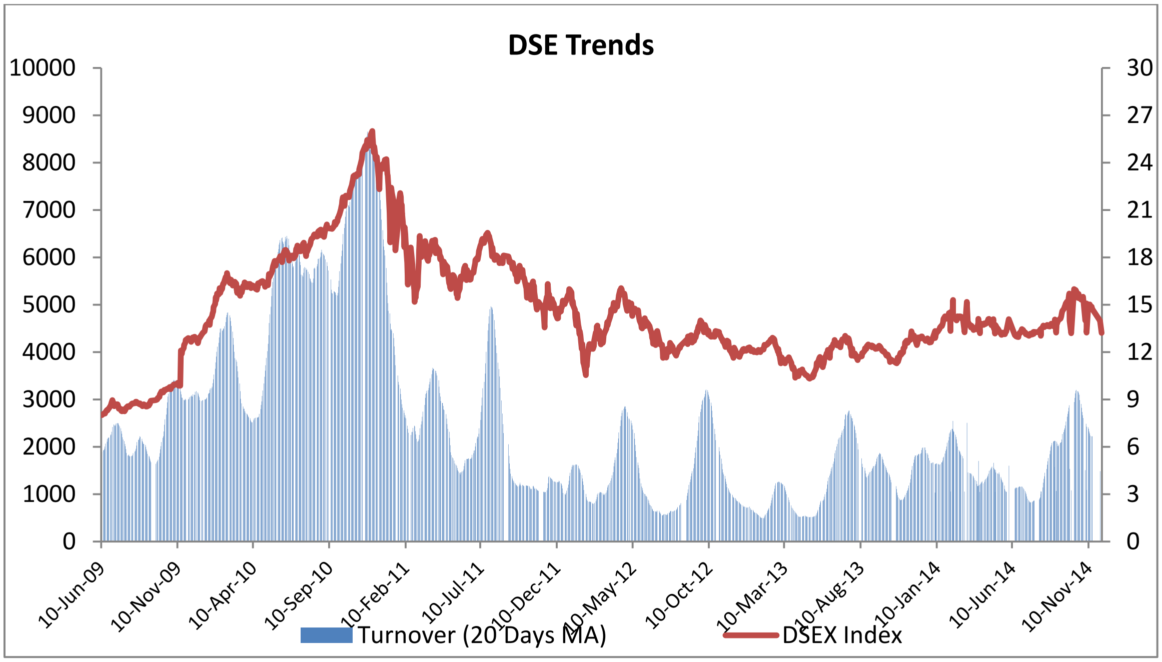
Market capitalization of the stock market reached 31.8% of the total financial sector in 2010, when the capital market passed through a bubble phase.

The Dhaka Stock Exchange Limited launched three new indices, the DSE Broad Index ("DSEX") and DSE 30 Index ("DS30") which have been designed and developed by S&P Dow Jones on 28 January 2013 and the DSE Shariah or DSES Index from 20 January 2014. The Exchange Demutualisation Act, 2013 was passed by the National Parliament of Bangladesh on 29 April 2013 and gazetted on 2 May 2013. An Appellate Board by retired Judges from High Court Division has been formed to settle the capital market related investors' claim. Surveillance software has been installed to ensure transparency and accountability in the capital market through strengthening the monitoring of transactions. The task of amending the 'Securities and Exchange Commission Act 1990' and Securities and Exchange Ordinance 1969" has been completed.

3. Another Turbulent Episode, 2009-14

Bangladesh stock market had passed through a turbulent period in recent years. Following a bull run that started in second half of 2009, the stock price index as measured by DGEN Index reached a peak of 8919 in December 2010. Market turnover as percentage of market capitalization also increased to 19% in 2006 to about 114% at its peak coinciding with the surge in the DGEN Index. Market capitalization as a percentage of GDP increased from 5.5% in 2005 to more than 46% at its peak. Like all bull runs and the associated bubble, the stock price bubble in Bangladesh also came to an end in December 2010. In the midst of the correcting phase, the Government had announced a number of initiatives to support the stock market and used sizable amounts of public funds to support the market without any visible impact. The DSEX Broad Index declined and as of November 2014 stood at around 4917 level. At the same time the market remained volatile, directionless, and the daily value/volume of transactions plummeted from their peak levels. The market sentiment was also suffering from continued overhang arising out of unsettled BO accounts of retail market participants. More recently, political turmoil and hostilities of 2013 also had a toll on the market.

Figure 4.4: Developments in the DSE Index and Turnover



Source: DSE

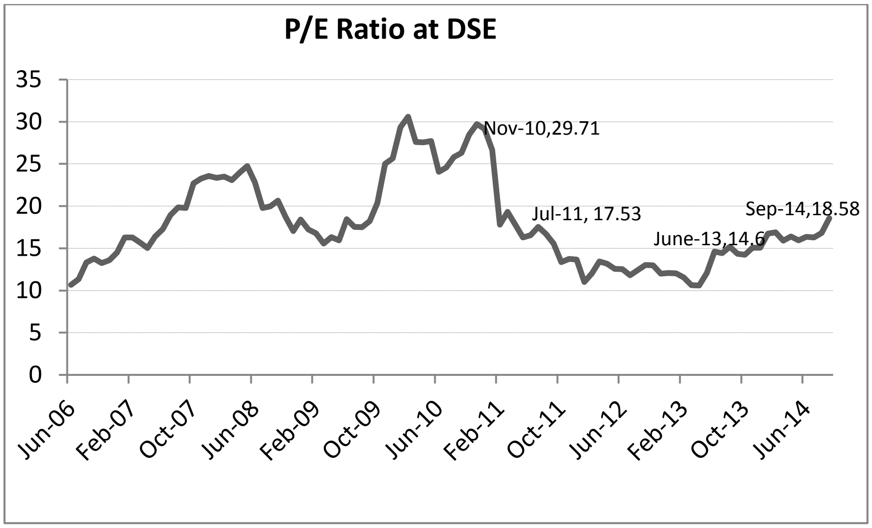
The state of stock market had intensified pressures for improved governance through market reforms both in terms of legal/ regulatory and operational aspects. There was also continued pressures for further government intervention to support the market through supporting/floating of government sponsored funds (like Bangladesh Fund) and other forms of reliefs in the context of the forthcoming budget. Over time however, the market has stabilized and market valuations and volumes appear to be at satisfactory levels, despite widespread perceptions that the market is underperforming in terms of volume and prices. The basis for this assessment is provided below on the basis of developments in key market indicators.

4. Recent Levels of Key Market Indicators--Price-Earnings Ratio, Dividend to Yield Ratio and Market Turnover

As regards valuation, certainly the current Price-Earning (P/E) Ratio at its recent low of 10.6 as of March 2013 was certainly much more attractive from investors' perspective compared with the average P/E Ratio of 30.6 at its recent peak in February 2010 (Figure 4.5). It is certainly true that stocks traded in DSE have become much cheaper after the correction relative to their recent past peak levels. Accordingly, investors' interests returned and the stock prices in recent months have recovered significantly and the P/E ratio hit a three-year high of 15.1 toward the end of

2013. The P/E ratio has increased further in 2014 and reached 18.58% as of September 2014. Hikes in individual share prices as investors started to return and a decline in earnings by listed companies amid a prolonged political turmoil resulted in the rise in market P/E ratio.

Figure 4.5: P/E Ratio at DSE



Source: DSE

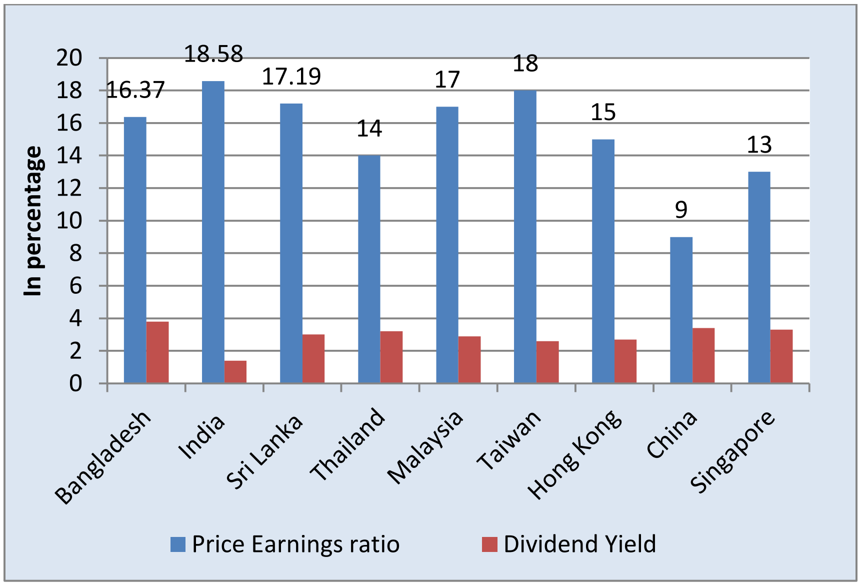
A review of DSE's past performance and a comparison with regional comparators indicates that:

- DSE average P/E ratios were not low even after the correction compared with the P/E ratios observed in the period prior to the beginning of the recent bull-run in the DSE. The P/E ratios generally ranged between 10-18 during 2005 and 2006.

- An international comparison with a wider range of markets indicates that the average P/E Ratio of 16.37 for the DSE in 2014 was in line with the levels observed in most countries such as Thailand, Malaysia, Sri Lanka and Hong Kong. As a matter fact, Bangladesh P/E ratio is significantly above the levels of China, Singapore, and Thailand.

- Bangladesh's dividend yield at close to 4% also compares very favorably with all other regional comparators.

Figure 4.6: P/E Ratio as on June 2014

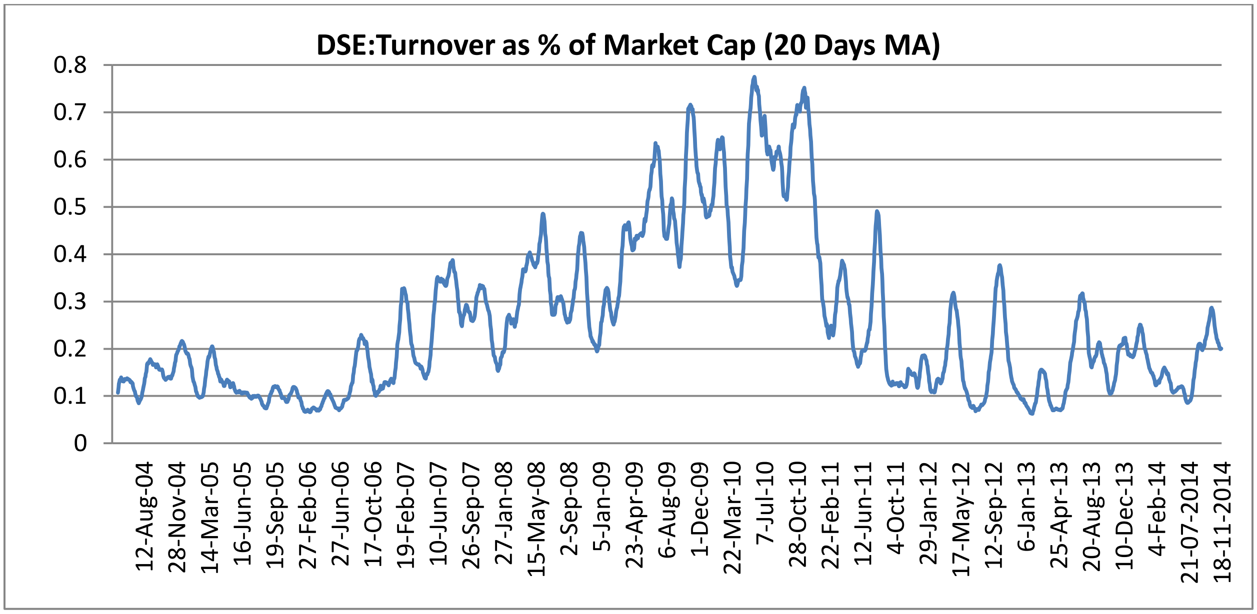


Source: Bangladesh Bank

Market dynamism is generally measured in terms of market activities like the value of daily turnovers or volume of buys/sales. Thus most market participants and analysts are concerned about the sharp fall in daily turnover to less than Tk. 2 billion in recent years compared with the all time peak of Tk. 30 billion in late 2010. The marked decline in daily DSE turnover needs to be examined more carefully to determine whether the decline is indeed unusual for the size of the market measured in terms of market capitalization.

In order to filter the volatility in daily turnover due to various reasons we measured the 20-day moving average for DSE daily turnover as percent of market capitalization for a longer period. It is noteworthy that, despite smoothing out through the moving average method, the ratio has been quite volatile and broadly followed the trend in the DSE Index. Both of these phenomena are also observed in other markets that passed through similar boom and burst. What is important is that despite the steady decline, the turnover ratios were still comparable with its levels recorded during 2004-06 and before when the market was functioning in a stable environment.

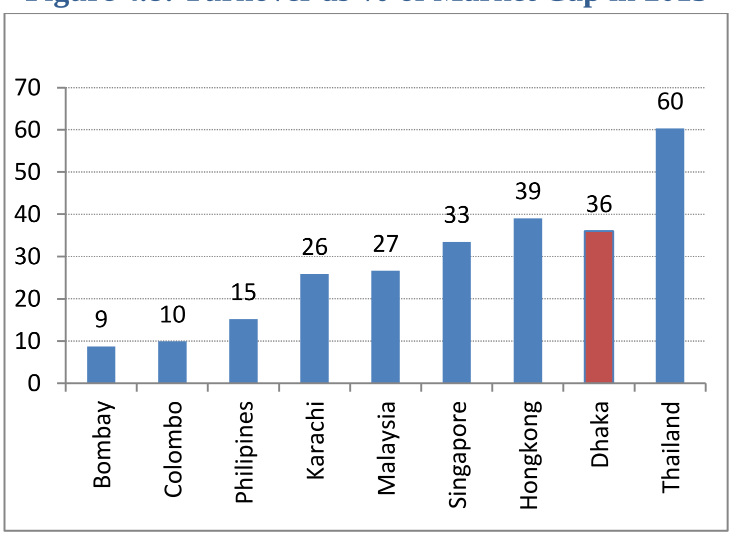
Figure 4.7: DSE Turnover as % of Market Cap (20 Days MA)



Source: DSE

In addition to looking at the turnover to market capitalization ratio over time for Bangladesh, we also compared the annual market turnover as a percent of market capitalization for 2013 for a selected number of countries. Certainly for 2013, many months after the correction, the annual turnover ratio for DSE at 36 percent compared quite favorably with most of the regional comparators except for Thailand which is an outlier.

Figure 4.8: Turnover as % of Market Cap in 2013

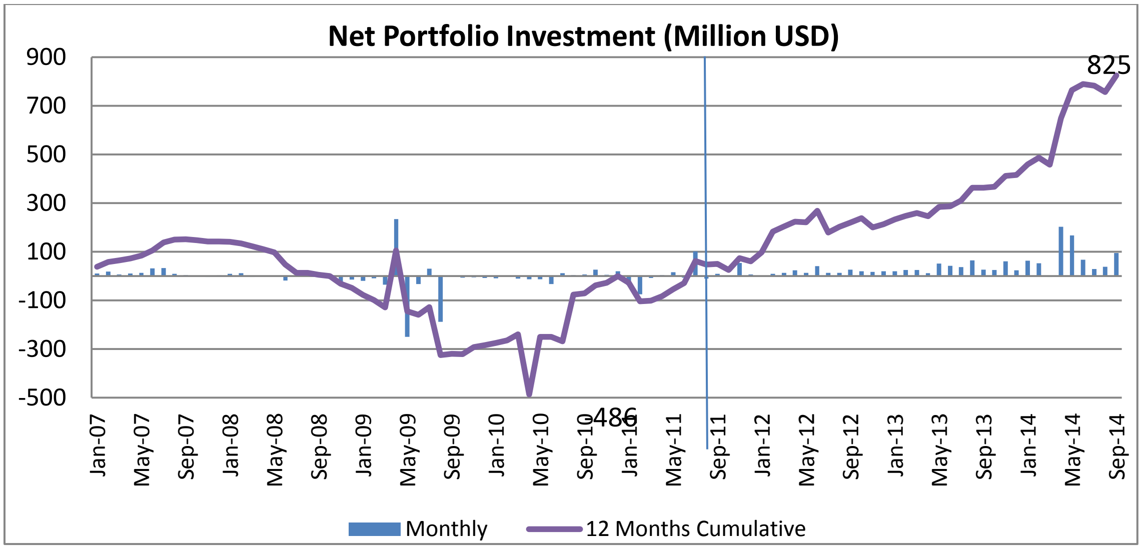


Source: DSE and Bangladesh Bank.

5. Do We Observe a Sustained Recovery in the Bangladesh Market?

Foreign portfolio investment is generally considered to be a good indicator for market valuation and future performance/outlook for the stock market. Developments in net foreign portfolio investment position in Bangladesh also pointed to future developments in the stock market in the period leading up to the peak of the bubble and thereafter. In the period up to October 2007, the increase in the stock price index in DSE was primarily driven by market fundamentals and attractive valuation.

Figure 4.9: Net Portfolio Investment (Million USD)



Source: Bangladesh Bank

The dual positive characteristics of the market helped attract foreign portfolio investment in the DSE through October 2007, with the 12-month cumulative net inflow increasing to $148 million in October 2007. As the market continued to surge and market became increasingly over-valued, foreign portfolio investors started to pull out of Bangladesh market and 12-month cumulative net withdrawal from DSE peaked to $486 million by April 2010. It is believed that by the time the stock price index peaked in December 2010 virtually all foreign portfolio investment was pulled out of the market. During October 2008 through December 2010, every month sizable amounts were withdrawn from the stock market (except 2 months) as foreign portfolio investors booked their capital gains and waited for the market correction.

As the market correction was largely over by April 2011, portfolio investors started coming back to the market from May onwards. Every month, except one, new money poured into the stock market on a net basis and by September 2014 the 12-month cumulative net investment increased to $825 million. We consider this noticeable turnaround in net portfolio investment as one of the signs of market recovery because foreign portfolio investors are being attracted in increasing numbers by the prevailing stock price valuations and the positive macroeconomic and growth outlook.

The other area where we notice some recovery is in the number of IPOs and the total amount raised through IPOs during the post correction period. In 2011, in the immediate aftermath of market correction, 9 IPOs were launched by enterprises to raise Tk. 13.8 billion. This increase was primarily due to companies which were already in the pipeline for IPO before the market crash. The number of enterprises floating IPOs in 2012 increased marginally to 10 and the total amount raised decreased to Tk. 7.7 billion. The number of new issues bounced back significantly in the first quarter of 2013 with 17 enterprises issuing IPOs in the amount of Tk. 12.6 billion.

Table 4.2: New Issue of Shares and Bonds Since 2009

	Number of Scripts	**Sum of Size of the IPO (In Million Taka)**
2009	**11**	**6,358**
Share	11	6,358
2010	**6**	**4,516**
Bond	1	400
Share	5	4,116
Of which Book Building	1	1,656
2011	**10**	**14,074**
Bond	1	300
Share	9	13,774
Of which Book Building	2	7,948
2012	**10**	**7,743**
Share	10	7,743
2013	**17**	**12,584**
Share	17	12,584
2014*	**16**	**8,844**
Share	16	8,844
Total	**64**	**60,143**
*** The figures for 2014 are till the month of August**		

Source: DSE

6. Capital Market Activities in FY13

Primary Issuance

Sixteen companies raised new equity of Taka 8.84 billion in the capital market in FY14, lower than the Taka 12.58 billion raised by the seventeen companies in FY13. The volume of public offerings in FY13 was oversubscribed more than three times indicating a shortage of new securities in the primary market. Bonus shares worth of Taka 34.4 billion were issued in FY13 by one hundred and sixty one companies against retained profits. This was lower than Taka 43.0 billion issued in FY12 by one hundred and fifty seven companies.

Secondary Market Activities

As a percent of market capitalisation the financial sector dominated with 37.2 percent share, followed by services and miscellaneous (33.7 percent), manufacturing (28.8 percent) and corporate bonds (0.3 percent) at the end of June FY13. In Dhaka stock exchange (DSE), market capitalisation inclusive of new issues increased by 1.5 percent to Taka 2530.2 billion or 24.4 percent of GDP at the end of FY13 from Taka 2491.6 billion at the end of FY12. In Chittagong Stock Exchange (CSE), it grew by 2.6 percent to Taka 1919.9 billion or 18.5 percent of GDP at the end of FY13.

Non-Resident Portfolio Investment

Gross investment inflow in shares and securities of the stock exchanges by nonresidents through Non-resident Investor Taka Account (NITA) increased to Taka 18.0 billion in FY13 from Taka 15.7 billion in FY12. Gross outflow as repatriation of sale proceeds also increased to Taka 7.8 billion in FY13 from Taka 6.7 billion in FY12. From April 1992 to June 2013, the gross investment inflow stood at Taka 87.4 billion against gross outflow as repatriation of sale proceeds of Taka 75.1 billion.

7. Are Regulatory Reforms to Govern the Stock Markets Progressing Well?

The recent stock market debacle exposed the inadequacies in the stock market operations and the prevailing policies and practices. The report prepared by ADB identified “government tutelage over the capital markets” as the most critical problem “holding back sector development and constrains responsible institutions from carrying out their mandates effectively.” Combined with strong vested interest have resulted in entrenched status quo.

There is a general degree of convergence among the practitioners and market analysts about the key problems facing the capital markets, which are:

- Limited SEC capability in areas of regulation, surveillance, and enforcement

- Limited financial stability oversight and policy coordination between SEC, Bangladesh Bank and the Ministry of Finance
- Weak regulation, governance and operation of stock exchanges
- Small institutional investor and mutual fund industry: underdeveloped insurance industry serving only 1%-2% of population; nascent mutual fund segment of the financial sector
- Limited supply of bonds and equities

The key recommendations were:

- Demutualization of stock exchanges
- Enhanced coordination between regulators to enhance financial stability
- Enhancing institutional investor demand and promote the mutual fund industry
- Enhancing supply and demand of equities and bonds

A review of reform measures recommended after the stock market debacle indicates that most of the key measures have been implemented except for one although almost 4 years have passed since the bubble busted in late 2010. In particular, despite delays experienced in submitting the draft Demutualization Act to parliament and the Banking Control Act (BCA), both acts have been approved by Parliament and the demutualization of Dhaka and Chittagong stock exchanges have been completed. Submission of the new Financial Reporting Act containing the provisions for establishing an independent Financial Reporting Council has been significantly delayed due to resistance from some quarters. The draft law has been approved by the Cabinet in November 2014 and expected to be submitted to Parliament in the coming months. The government should use its political capital to steer the draft law through Parliament. Reforms which could be implemented through administrative circulars—such as devolving of treasury bills and amending the Mutual Fund Rules—are already in place.

Table 4.3: Key Policy Actions and Current Status of Reforms under the Second Capital Market Development Program of ADB

Policy Actions	**Status**
Submission to Parliament of amended BCA with the objective to contain risks posed by equity markets through consolidated supervision.	BCA was passed by Parliament on 7 July 2013
Reduce banks equity risk exposure by introduction of BB Guideline to establish a limit for total direct and indirect exposure to equity risk as a percentage of capital, applicable on a solo and consolidated basis once the amended BCA is passed.	Bangladesh Bank has issued the circular with regard to equity risk exposure as percentage of capital applicable on a solo basis on 16 September 2013.

Policy Actions	**Status**
SEC has undertaken a review of the capital requirements for intermediaries through a risk-based supervision approach.	The review was completed on 5 October 2013.
Reports generated from the Market Surveillance System to be part of improved monitoring of the capital markets.	A manual for usage of the surveillance system and report generation was prepared. All activities related to this action were completed on 5 October 2013.
Submission to Parliament of FRA Bill to include (i) establish an independent Financial Reporting Council (FRC) (ii) license auditors and accountants and (iii) establish an independent administrative tribunal to hear appeals	Cabinet approval of the FRA bill has been obtained in November 2014. Has not been submitted to Parliament yet.
SEC has established and staffed the Office of Chief Accountant including adoption of guidelines for the accountants and auditors.	Complied With.
Establish a special tribunal for capital market related cases.	Capital market tribunal was established on 7 January 2014.
Submission to Parliament of Demutualization Act. (SEC and MOF-BFID)	Demutualization Act was passed by Parliament in April 2013.
BB to devolve at a yield which is the average of all submitted bids by the Primary Dealers (PDs) and non-PDs in an auction, excluding outliers.	Circular published on 3 Oct 03, 2012.
Exemption of the 3% tax on IMP premiums by amending Section 16 (E)/53L and exemption of transactions taxes for bonds by amending Section 53 (BBB) of the Income Tax Ordinance	Complied With.
Ensure that the sale of receivables to an SPV in connection with the securitization of assets is exempted from the stamp duty on conveyance of assets	Complied With. This was included in the Stamp Act amendment during the budget session in June 2013.
Circulars Implemented and fully operationalized	Complied With.
Amend Securities and Exchange Commission	Complied With. The rules were issued in

Policy Actions	Status
rules 2001 (Rule no. 55) to allow Asset Management Companies greater investment flexibility by allowing them to reduce their exposure to equity securities below the stipulated 75% if stated in the fund's prospectus	March 2013.
Allow investors in private sector open end mutual funds the same tax advantage as ICB open end mutual funds as the one applicable to investors in ICB open-end mutual funds	Complied With. This was included in the Finance Act during the budget session in June 2013.

8. Observations Related to Recent Capital Market Developments and Policy Recommendations

Following a major correction, DSE stocks are found to be appropriately priced and the decline in daily market turnover is also in line with what we observe in many healthy and stable stock markets in our region. Market volatility measured in terms of movements in the DSE Index and the average turnover was high after the starting of the market correction but the volatility is declining steadily and currently not out of line with market volatilities observed in other markets which had gone through similar corrections and were at the same stage (i.e., several years after the start of market correction).

Government's efforts to stop the decline in the DSE Index did not predictably bring any positive result. The interventions temporarily pushed the index upward, but resumed the declining trend soon thereafter ignoring the bumps. Government interventions only delayed the process of market correction, thereby prolonging the agony without any real gain and sizable financial losses for the public sector financial institutions.

The observed volatilities notwithstanding, there are positive signs which may be characterized as indications of future market stability. Foreign portfolio investment has been increasingly noticeable, attracted by proper valuation, macroeconomic stability and growth potential of the economy. Increasing numbers of IPOs are also taking place, as more and more companies are approaching the stock market for funding their growing operations and expansion programs. We however must caution that any renewed intensification of political tensions and hostilities may stall or even reverse the gained observed in the period up to November 2014.

The period after the bursting of the bubble is normally the best time to launch carefully thought through reforms. In the case of Bangladesh the reform agenda have largely been identified, and despite some delays much of the reform agenda have been implemented. In particular, the demutualization of stock exchanges to segregate ownership, management and trading rights of members will help convert the two exchanges into commercially and professionally run organizations. Improved governance structure should also help develop the market and attract new investors.

Enhancing supply and demand for equities over time will require restoration of confidence through:

- Upgrading of accounting and auditing standards to enhance market confidence
- Establish an independent Financial Reporting Council to adopt and monitor International Accounting Standards (IAS) and International Standards of Auditing as well as license accountants and auditors
- Establish an Audit Committee to supervise companies' internal controls, accounting policies, and compliance with IAS

The absence of the FRA Act is seriously undermining the restoration of market confidence through improvements in quality of financial reporting.

Developing an organized investor base through a robust mutual fund industry will require going beyond what has been done so far and observe how the sector responds to the steps already taken. Making the playing field even by requiring ICB funds to be fully compliant with all mutual fund regulations will be important in this regard.

Government should continue to issue treasury bills and bonds at market rates and thereby develop a liquid bond market and reliable yield curve. In addition to stopping the policy of devolvement by Bangladesh Bank, which it is addressing now, enhancing market liquidity will require increasing the average size and reopening existing ones. In addition to abolishing the transaction taxes on bonds, development of the corporate bond market will also require improving the regulatory process for private placements by balancing investor protection with ease of approval.

A comprehensive review of taxation of the stock market is long overdue. Such a comprehensive review should treat taxation of income from the stock market in the same manner as any other income and at the same time getting rid of inefficient taxes and double taxation of income if that exists. At the moment the tax regime is full of inconsistencies due to ad hoc measures and not in line with international best practices.

Finally, the government should stop the annual ritual of "allowing black money into the stock market." Stock market should not be painted as the playing ground for legalizing illegally obtained money.

A comprehensive review of the operations of the stock market in Bangladesh by ADB also identified a number of important operational and market development issues and made recommendations relating to: (i) primary and secondary market development, improved governance through Self Regulatory organizations (SRO); (ii) trading, clearance and settlement of stocks; (iii) institutional investors, financial literacy and non-resident Bangladeshi's; and (iv) development of derivatives and securitization markets. The specific recommendations relating to these four important market segments and market participants or stakeholders are noted below:

Recommendations for Governance and Operations of Primary and Secondary Markets and Self Regulatory Organizations

- Protection of the investors should be the top priority of accounting firms, merchant banks and stock exchanges. Establishing a strong Self-Regulatory Organization (SRO) to monitor and discipline their members to minimize the involvement of the Securities and Exchange Commission (SEC) will be important in this regard.
- The industry needs to define the role of SROs in oversight and adopt international best commercial practices.
- The SEC needs to officially recognize many of the SRO's and begin the process of integrating Bangladesh's markets with international best practices.
- Due to the slowing down of business activity and loss in revenues, it is recommended that The Stock Exchanges explore new channels of revenue generation as suggested by the World Federation of Exchanges. A demutualized DSE should review its capital improvement program to determine what new investments are necessary and the DSE should delist the defunct shares and debentures.

Recommendations for Bangladesh Trading, Clearance and Settlement

- Exchange risk management should be improved. To prevent inadvertent short selling, the trading system should import positions from CDBL and track them while buying and selling orders.
- To prevent duplication of clearing and settlement functions, the post-trade functions of the two exchanges, together with CDBL, should be merged into a single organization.
- CDBL systems should be upgraded to provide: (i) settlement of exchange trades on a Delivery versus Payment (DVP) basis on settlement date; (ii) settlement of movements between brokers and custodians on a DVP basis; and (iii) a full and accessible audit trail for all movements.
- Currently each issuer distributes dividends to end investors. This system needs to be replaced by one where CDBL should distribute cash dividends and other income payments to participants, on receipt of an omnibus payment from the issuer.

- Steps should be taken to evaluate the benefits and feasibility of a Central Counter Party (CCP) system for exchange-traded equities.

Recommendations for Institutional Investors, Financial Literacy and Non-Resident Bangladeshi's

- As institutional investors have different investment preferences, the laws and regulations concerning the ability of investors to buy various securities should be reviewed and made coherent.
- Financial literacy among retail investors in Bangladesh is an area that needs attention, the SEC with support from multilateral organizations like ADB should consider building a financial literacy unit within the BICM.
- Initiate a policy discussion at the ministry level on how to capture savings of Non-resident Bangladeshis and assess whether public and private pension systems are beneficial for the nation.

Recommendations for Derivatives and Securitization Markets

- The development of a legal and regulatory foundation to accommodate derivatives, by amending the company's act; banking and non-bank financial institutions acts; trust and bankruptcy acts; introduction of specialized derivatives legislation that provides the legal basis for derivative contracts, netting, etc.
- It is recommended that the authorities and market participants begin developing risk management systems to identify measure, monitor and control various risks.
- The authorities and market participants should begin a dialogue on the structure of a future derivatives industry. For instance, if derivatives will be: exchange traded and/or OTC traded; and whether to establish a CCP.
- To concentrate liquidity in a few derivative instruments, it is recommended that contracts be created in:
- ➢ interest rate derivatives (forwards or swaps in the 91-day Treasury bill and 5-year bond);
- ➢ foreign exchange forward or currency swap (one month or three month Dollar/Taka pair);
- ➢ a general stock index derivative initially aimed at institutional investors (an OTC index forward or swap, exchange-traded index future and option on future); and
- ➢ commodity hedges (OTC forward sales and purchases of physical commodities).

- As Securitization is information-intensive and requires enhanced disclosure and trading, the authorities and market participants should:
    - ➢ encourage the establishment or strengthen credit and property registries;

  - publish secondary market and OTC price and volume data (by industry associations);
  - encourage the establishment of pricing vendors;
  - (industry participants should) join international industry groups and SRO's; and
  - observe IOSCO's Code of Conduct for rating agencies.
- The Securitization Act of 2004 and/or tax legislation be amended to recognize "pass-through", true sale, and "bankruptcy remoteness" for securitizations.

Recommendations for Financial Sector Taxation Issues

- It is recommended that corporate taxes are reduced to OECD average level over time and taxes on inter-corporate transfers and the double taxation of dividends are eliminated in line with international best practices.
- Eliminate discriminatory tax treatment of financial institutions and the 3% tax on IPO premiums and exempt bonds from transaction taxes. Introduce a flat, say 5%, tax on short-term capital gains irrespective of the entities. Reduce or eliminate tax on long-term capital gains and increase the deductibility of the capital losses.

Recommendations for the Legal/Regulatory Framework

- **Principles relating to the Regulators**: The responsibilities of the regulators should be clear and objectively stated. The SEC and BB should develop an MOU or protocol on the collection and sharing of supervisory information, risk assessments and coordinating supervisory activities, and in enforcing conduct requirements. The securities laws, rules and orders need to be better updated and compiled for clearer understanding and accessibility, including official English translations. The regulators should be operationally independent and accountable in the exercise of its functions and powers and not subject to any political pressures. The regulators should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers. The SEC is currently prevented from fully utilizing its funds due to the government's policies which has resulted in it becoming underfunded, understaffed and can minimally perform its regulatory duties. The SEC should be afforded broader access to its fund without tight GoB expenditure approval and paid competitive. It should adopt clear and consistent regulatory processes and should eliminate anomalies in the case of SEC prosecution of criminal cases. The staff of the regulator should maintain the highest professional standards including standards of confidentiality by adhering to a comprehensive Code of Conduct.

- **Principles relating to the to Self-Regulation**: The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets. The SEC needs to have in place an on-going program to oversee them because of staffing and capacity limitations. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

- **Principles relating to Enforcement:** The regulator should have broad powers for inspection, investigation and surveillance and to review bank account information and implementation of an effective compliance program. The regulator should have a comprehensive enforcement power which however depends on the quick, fair and effective disposal of criminal cases by the Court. For that reason the SEC has proposed establishment of a Special Capital Market Tribunal.

- **Principles relating to Cooperation:** The Regulator should be given the authority to share both public and non-public information and should establish information sharing mechanisms that set out when and how they will share such information with domestic and foreign counterparts. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers. The SEC should begin the process of cross-border cooperation and information sharing with regulatory regimes around the world.

- **Principles relating to Issuers:** There should be full, timely and accurate disclosure of financial results and other information that is crucial to investors' decisions. Holders of securities in a company should be treated in a fair and equitable manner by allowing effective SEC oversight of takeovers and amendment of rules. Accounting and auditing standards should be made internationally acceptable and of a high quality. IAS (IFRS) and ISA need to be implemented.

- **Principles relating to Collective Investment Schemes:** The regulatory system should set eligibility criteria and regulation standards governing the legal form and structure of collective investment schemes and the segregation and protection of client assets for those who wish to operate a collective investment scheme. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor’s interest in the scheme.

- **Principles relating to Market Intermediaries:** Regulation should provide for minimum entry standards for market intermediaries and require demonstrating proficiency. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters. There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

- **Principles relating to Secondary Markets:** The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight. In recent years, this oversight has weakened, limited by lack of SEC resources and capacity. There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants. Regulation should promote transparency of trading and be designed to detect and discourage manipulation and other unfair trading practices. It should also aim towards ensure proper management of large exposures, default risk and market disruption.

V. BOND MARKET

In a well diversified financial system bond market has a very important role to play. Bond financing allows diversification of credit and investment risks and thus reduces macroeconomic vulnerability to shocks and systemic risk through. The government bond market forms the backbone of a modern securities market in both developed and developing countries. The availability of long-term funds for specific uses such as for infrastructure development and long-term industrial financing is facilitated by the debt market. A developed debt market also infuses greater transparency in credit allocation in view of the information contained in market determined rates. As it is difficult for the government to intervene through the debt market for directing subsidized lending compared with the banking system, debt market reduces the amount of bad loans to a certain extent.

The bond market links the issuers having long-term financing needs with investors willing to place funds in long-term interest bearing securities. When firms can raise funds by issuing bonds, they are less dependent on banks and less exposed to vulnerabilities of the banking system. Corporations suffer greatly when there is liquidity crisis in the banks and bond is their primary source of funds. Besides, a well developed bond market reduces banks' monopoly over interest rate on both deposit and credit by offering alternative options.

Table 5.1: Performance Indicators of Listed Securities at DSE as of September' 2014

	Number	Total Number of Shares/ Certificates (in 000s)	Total Issued Capital (Mil Taka)	Market Capitalization (Mil Taka)
All Companies Shares	271	43987000	444,889	2,721,426
All Mutual Funds	41	4135000	41,349	29,210
All Debentures	8	409	140	576
All Listed Govt. T-Bonds	221	5485	549,381	549,381
All Listed Corporate Bonds	3	6267	6,267	6,469
Total	544	48134000	1,042,026	3,307,062

Source: Monthly Reviews, DSE

A well-functioning bond market offers the borrowers flexibility to diversify their sources of funding and provides them with alternative sources of raising funds having different credit risks and maturities for matching expenditure needs. Amidst the stock market debacle in recent years, many financial experts may have felt the need for an established bond market to offer alternative options of investment for the investors.

Bonds, though they have worldwide popularity as security, have little impact in the securities market of Bangladesh with trading of only a few enlisted bonds. Currently Bangladesh bond market plays a very insignificant role in the economy. Neither the policy makers nor the corporations have shown any substantial interest in bonds. In the absence of significant number of bonds, general investors have little idea about how bond market should work.

Government Bonds

The bond market in Bangladesh is dominated by the fixed income government debt instruments, namely the National Saving Certificate. These bonds are not tradable in the secondary market. The interest rates on this saving certificate are generally higher than that of other bonds in the market. The national savings scheme is aimed at mobilizing the savings of small investors and pensioners at attractive interest rates. Under the National Savings Directorate, formed under Public Debt Act, 1943, national savings certificates are sold through 9,000 post office branches and 3,300 commercial bank branches functioning as commission agents. Bangladesh Bank collects the sales proceeds and reimburses the seller at the time of encashment (redemption). Government uses 3 to 5 years term savings certificates (Sanchaypotro) for the purpose of domestic borrowing from the public.

Other government debt instruments that are available are the treasury bills and treasury bonds with the capital raising pattern shifting from a focus in treasury bills to a noteworthy increase in treasury bonds. Banks and financial institutions are the main buyers of treasury bonds. Treasury bills and bonds are short term and long term obligations issued by Bangladesh Bank on behalf of the Government of Bangladesh. These are the indirect monetary instruments that the BB uses for debt management purpose. The securities are issued through an auction process where the allotments are awarded to the bids which fill the notified issue amount ranging from the lowest to highest yield. Pro-rata partial allotments are made for bids at the cut-off-yield. For short term borrowing up to 364 days, Government of Bangladesh uses Treasury Bills (T-Bills). Bangladesh Government Treasury Bonds (BGTB) are being used for borrowing for both medium and long term maturities ranging from 2 years up to 20 years.

Commercial banks have an obligation to purchase government securities as it is accepted as a security to meet their Statutory Liquidity Requirement (SLR) under the Banking Companies Act. In December 2013, government issued 5 and 10 years maturity treasury bonds and in July 2007, launched bonds of 15 and 20 years of maturity. The capital raising pattern has been changed from a focus in treasury bills to a noteworthy increase in treasury bonds. The ratio of treasury bills to treasury bonds has changed from 20:80 in 2005 to 80:20 in 2011. The share of treasury bonds in total debt/savings instruments is gradually increasing whereas that of NSD certificates is declining. As of June 2014, 46% and 34% of total government securities were of treasury bonds and NSD certificates respectively (Table 5.3).

Table 5.2: Outstanding Stock of Treasury Bills, Bonds and NSD Certificates (in Billion Taka)

	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
T-bills							
91-day	68.5	65.5	85.5	102	114	115	99
182-day	67	75	83.5	90.6	103	114.5	117
364 day	106.5	126	145.5	161.3	185.8	193.8	215.8
2-year	0	0	0	0	0	0	0
5-year	0	0	0	0	0	0	0
BGTB							
2-year				21	36	49	63
5-year	248.7	258.5	274.1	279	283.5	290	301.2
10-year	325.9	346.9	364.9	373.9	383.8	395.3	404.7
15-year	104.4	107.4	113.4	117.9	122.4	128.9	140.4
20-year	86.1	89.1	92.1	96.6	101.1	107.1	117.1
Sub Total	1007	1068.4	1165	1242.2	1329.6	1393.6	1458.2
NSD Certificates	640.9	646.1	645.1	666.1	683.7	719.7	764
Total	1648	1714.5	1810	1908.3	2013.3	2113.3	2222.2

Source: Bangladesh Bank

Table 5.3: Percentage Share of Government Securities in Total Debt/Savings Instruments

Period	T-bills (91day, 182day, 364 day, 2&5year)	BGTB (2, 5, 10, 15 & 20 year)	NSD Certificates
Dec-10	8%	39%	54%
Dec-11	10%	43%	47%
Dec-12	15%	46%	39%
Dec-13	20%	46%	34%
Jun-14	19%	46%	34%

Source: Bangladesh Bank

Corporate Bond

The corporate bond market in Bangladesh remains at a nascent stage, with a shallow debenture market. In 1987–2005 only 17 debentures were issued through public offerings. The eight debentures still outstanding in 2014 had an issue value of only $2 million. The corporate bond market faces important constraints—but also a potential for growth in bank and infrastructure bonds that could spark its development. There are only 3 corporate bonds currently operating in the country -- IBBL Mudaraba Perpetual Bond, ACI Zero Coupon Bond and BRAC Bank subordinated Bond.

Table 5.4: Corporate Bonds of Bangladesh

Name of Instrument	Listing Year	Market Capitalization (million Taka)	Paid-up Capital (million Taka)
ACI Zero Coupon Bond	2010	314.058	267
BRAC Bank subordinated Bond	2011	3015.00	3000
Islamic Bank Bangladesh limited (IBBL) Mudaraba Perpetual Bond	2007	2915.25	3000

Source: Dhaka Stock Exchange.

1. Constraints on the development of the Bond Market

The bond market of Bangladesh is very underdeveloped. A number of factors including supply side constraints such as a lack of benchmark bonds, inadequate regulatory system, market distortions due to national savings scheme, and a lack of interest from private companies in bond markets because of high costs, default of debentures in the past, and the general preference of investor in the equities rather than in bonds are responsible for the slow growth of the bond market in Bangladesh[4]. Although efforts are made by the government to issue benchmark bonds, they are not yet sufficient. Moreover, secondary market in the government securities is illiquid, which hampers the proper pricing of treasury bonds in the primary market.

[4] The Aries Group (2012). Bangladesh TA-7811: Capital Market Development Program II presented to Asian Development Bank (ADB), April 2012.

Even if there is a full-fledged legal/regulatory framework, there is need for a change in some existing laws and measures in the form of tighter regulation, boosting the authority's political independence and access to resources. Some of the corporate debentures (bonds) issued in early 1990s defaulted on the interest payments. At that time, the market was not well regulated and credit rating was not required. In addition, failure of trustees to enforce debenture holders' rights has also eroded investor confidence in the market and legal framework for contract enforcement. The negative image of past bond issue has not yet been cleared, which has created a reluctant sentiment on the part of investors to purchase corporate bonds.

In order to attract foreign institutional investors or large scale investments, Bangladesh needs to develop future markets for foreign exchange and interest rate risks since currency conversion rates would impact return on investment from interest income for long-term investments and eventual repatriation of capital. In emerging markets, over a ten year long lending horizon, without the ability to hedge against interest and exchange rates in the face of any unmitigated risks or crises in the financial system, investors will never invest large amounts of capital unless they are allowed to hedge a certain portion of that capital. Currently, there is no forward market for investments longer than 3 to 6 months. It is thus important that the financial sector is organized in such a manner that longer maturity hedging instruments are available for investors. With the availability of proper market based hedging instruments, the volume of foreign exchange trading can be increased significantly, thus also increasing the size of the capital market. Investors are more likely to hold trading portfolios if hedging against certain risks 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. When hedge vehicles are used as primary instruments, they may become risky business. However, 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. Similarly, short selling arrangement can also help the investors. Currently the market is structured in such a way that all foreign investments at the time of repatriation are guaranteed by the government at the taka-dollar exchange rate value initially agreed upon, as commonly practiced in the case of power sector and other infrastructure investments in Bangladesh. In this setting, the investors are essentially hedging all their investments, but the entirety of the risks lies upon the government. One option could be to transfer the risks onto the operators/investors instead of the government such that the government does not have to take any further risks. Under this arrangement, hedging through market rather than the government will reduce unmitigated risks for both government as well as the investors. Therefore, implementing risk management strategies in the financial sector should be a key priority on the agenda for the Seventh Five Year Plan. It is also important to caution that widespread introduction of derivatives to markets, in the absence of enabling legislation, accepted commercial conventions and risk control would also be imprudent.

The growth of the corporate bond market suffers due to the poor state of the Government bond market and obscure regulatory requirements and a long approval process. National savings scheme is intended to encourage individual savings at high interest rate. Considering that national savings certificates are risk-free bonds, interest rate is high, resulting in crowding out other savings products. This has caused a major distortion in the market. Therefore, a company has to offer higher coupon rate to entice investors to invest in corporate bonds.

When compared to other countries, Bangladesh falls behind with regard to the quality financial market infrastructure, including trading, clearance and settlement systems.

Much of the fraud and abuse in the past has originated from the poor performance of the primary and secondary markets. The institutional investor base is poorly developed and therefore retail investors should be encouraged to use the professional management of mutual funds. Majority of investors in Bangladesh are naive investors. Bonds are not so familiar among them. While they get overwhelmed by the abnormal capital gain from their investment in stocks, they take little interest in the debt securities where there is little or no possibility of major capital gain.

A thorough review of institutional investment regulations should be undertaken as investment regulations are ad hoc in nature. Mistrust and structural deficiencies in these markets likely will keep institutional investors away until deep reforms are introduced. In this regard, several key elements of the bond market infrastructure would need to be addressed during the Seventh Plan. Some of these elements include: 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. Ensuring transparent markets and systemic risk reduction would contribute greatly towards strengthening the regulatory framework and encourage institutional investment in the bond market.

Inefficiencies in the taxation system (transaction taxes and high rates) have reduced the attractiveness of financial markets and encouraged tax evasion. The high transaction costs of bond issuance are impediments. Specifically, the registration fee, stamp duties, annual trustee fees on outstanding amounts, and ancillary charges exert to dampen the bond issue, albeit registration fees for debentures (bonds) have been reduced in recent years.

It happens quite often that a number of banks form syndicates for financing large projects of companies. Syndicated loans are cheap as well as flexible and tailor-made, which makes bonds less attractive to the corporate issuers.

Finally, the Investment Corporation of Bangladesh, which enjoys a good reputation in the market, could play an important catalytic role through underwriting the developmental costs of quasi-public market infrastructure.

Recommendations for Government and Corporate Bonds

- The deepening of the government bond market through creation of large benchmark issues, re-openings and other techniques. The Debt Management Office should be strengthened so that the Ministry of Finance (MOF) can issue bonds at market rates.
- Asset backed securitization of debt provides a potentially important source of fund and reduces funding costs for investors and for the financial intermediaries by addressing the problem of asset-liability mismatches. Government has many projects like Jamuna Bridge and other roads and flyovers from which tolls are collected. If the income streams of these assets are securitized through issuance of asset backed securities/bonds, the bond market will get strong support.
- Secondary market trading should be encouraged by making trading of government bonds by primary dealers easier and allowing all government bonds to be accepted as collateral by the central bank.
- Development of organized futures market will help promote market liquidity and efficient pricing in the secondary market. In this context, derivatives which have emerged as an important feature of modern financial markets can play a vital role in managing the risks of underlying securities such as bonds, equity, currency exchange risk and interest rate risks.
- Facilitating private issuance of corporate bonds through the formation of a private placement and clarification of regulations of corporate bonds.
- Creating market awareness of corporate bonds.

2. The Current Status of Pension Funds in Bangladesh

Pension funds (especially public pension schemes) are one of the biggest sources of long term financing for major investment projects in the public and private sector for a lot of countries. Pension funds along with insurance companies are potential buyers of long-term bonds issues by public and private sector. But this is not the case with Bangladesh. Given the fact that Bangladesh is starved of long term financing for infrastructural projects through issuance of infrastructure bonds, the areas of pension funds, home mortgages and bonds are ones that need to be seriously explored. However, this sector suffers from a lack in interest and awareness which has resulted in a limited supply of Pension Funds and an even smaller demand of such funds. The Cash and Debt Management Committee (CDMC) at Finance Division is in charge of the pension sector development in Bangladesh to create stable demand of Government Securities.

In this regard Bangladesh Bank had appointed an expert from Index Capital Group based in New York. A detailed market study of the Pension/Provident Fund system was conducted to identify current practices, legal framework, limitations, and structural gaps in Bangladesh[5]. As of 2013, total PF system size was estimated at Tk. 31,500 Crore which was 4% of the GDP, accounting for 5% of total funds in government securities, and only 2.2 million employees had access to retirement savings, majority of who were public sector employees. Pensioners of the public sector are paid primarily from current tax revenues under a Pay-as-You-Go system; whereas private sector provident and gratuity funds, managed by trustee boards under employer-sponsored trusts, are usually not widely available.

Based on the findings of the study, the following observations were made in the report: a) increasing the pension access to majority of the workers in Bangladesh for providing retirement income, which will add 0.9 million new subscribers and increase the Pension Funds assets by Tk. 22,000 Crore in five to seven years; b) using new employees for the funding of Government Pension Funds and remitting 40% of that in the form of Treasury Bonds to new retirees; and c) and adopting practices used by majority of the Pension Fund systems in the world like providing investment guidelines based on risk return and age-wise asset allocation.

The study prescribed the following steps for the development of the Pension Funds system in Bangladesh:

- Establishment of a Pension Sector Development Unit (PSDU) that can be supervised by an inter-ministerial committee.
- Development of a National Pension Scheme (NPS) under the PSDU that can eliminate some of the shortcomings in the current PF system and be adopted within the existing framework.
- At a later stage, the Pension Funds sector can be brought under prudential regulations by Retirement Benefits Act.

3. The issuance of Municipal Bonds

A feasibility study for the development of Municipal Bonds and other approaches to finance Local Government Infrastructure has been undertaken by United Nations Capital Development Fund (UNCDF) (2013) and Asia-Pacific Regional Centre (APRC) under the directive of UNCDF , to assist developing countries supplement their existing financing sources for economic development in ways that are socially and environmentally sustainable. The focus of the study was on City Corporations and municipalities and certain autonomous entities as market financing is most feasible in an urban context. An analysis of both the issuer/demand side and the market/supply side of the municipal finance market was carried out to identify each side's

[5] Index Capital Group (2013). PF System- Final Report: The Development of Comprehensive and Sustainable Pension System in Bangladesh, 10 March 2013, Policy Guidelines for Formation and Operation of Comprehensive Pension/Provident Fund System. Index Capital Group: New York.

necessary elements for an efficient market. On the demand side, policies, capacities and the pipeline of bankable projects or city plans of City Corporations hold precedence. On the supply side, the elements that are of importance include market policies, market capacities, and interest of the investors.

The development of Municipal Bonds can be quite beneficial due to the following reasons:

- A strong need for local infrastructure finance in Bangladesh, including for investments related to climate change adaptation. If financing can be raised through municipal bonds, it could be used to finance specific projects or broader investment plans.

- The Annual Development Programme (ADP) system suffers from delays in payment for infrastructure projects for years, and often causes projects to compete for funding on non-economic/political criteria. In this situation, a market-based system with investors helping decide whether the projects have economic worth would play useful role.

Recommendations for the Development of Municipal Bonds

In order to develop the municipal bond market the following recommendations proposed in the UNCDF study may be considered:

- Blending of debt and grant funds will allow the effective interest rates to be lowered for municipal projects.
- As financial market intermediaries are not very familiar with municipal bonds, awareness needs to be built and the intermediaries would have to be educated.
- Credit rating agencies can develop ratings criteria and carry out evaluations of local government finances.
- Pilot municipal bonds can be floated in the short run with support from development partners and the government for development of systems and procedures.
- Competition between donor funds and market financing needs to be eliminated when the latter is more appropriate or else there will be no economic incentive for market financing, as donor funding will always be cheaper.
- It will be necessary to consult with the potential investors of the bond, and to familiarize them with the sector.
- The Bangladesh Mutual Development Fund (BMDF) could be a good candidate to provide market access for urban local bodies (city corporations and municipalities), by using a pooled financing or other intermediary arrangement and should be evaluated by the GOB.

- A number of the important reforms (such as those to make the capital markets more transparent, efficient, and competitive) are already underway and overtime will help pave the way for municipal bond market development.

VI. INSURANCE MARKET

1. Overview

The insurance sector was originally regulated by the Insurance Act, 1938 and after the Independence by the Insurance Act 1973. The industry has been growing steadily ever since despite many odds. Life-insurance and general insurance are the only two products being offered by the insurance companies where general insurance is mostly bought by companies. Health insurance and home insurance are very popular and mandatory in most countries, but insurance companies in Bangladesh are yet to offer such services.

The insurance law has gone through several amendments since 1984. The Insurance Act 2010 has been enacted by updating the provisions in the Insurance Act, 1938. The Insurance Development and Regulatory Authority Act 2010 has also been framed with a view to synchronizing functions of the existing Insurance Department in the spirit of the newly-enacted Insurance Act, 2010 to maintain proper control and supervision of the sector and protect the interests of policy holders and beneficiaries. Bangladesh remains behind its neighbors, both in terms of premium income and penetration. Only 1.5 per cent of the population has life insurance coverage in Bangladesh, as compared to 4.5 per cent in Pakistan and 7.5 per cent in India (as of 2010).

The Insurance Development and Regulatory Authority (IDRA) has been established for the insurance sector. The insurance companies including the state-owned enterprises need to be regulated under comprehensive laws and guidelines and need to be supervised by a strong regulatory authority. The Insurance Act 2010 stipulates that the sector needs to be managed properly and be strengthened by reducing business risks, and local and international insurance laws need to be harmonized in consideration of the socio-economic aspect of the country, and to protect the interest of policy holders and stakeholders of the insurance industry in Bangladesh.

The IDRA has been entrusted with functions and responsibilities under Section 15 of the Insurance Development and Regulatory Authority Act, 2010. Few of them are: development of the insurance industry in Bangladesh and advising the government in all respects for development of the industry; promoting development of training centres connected with the insurance industry to improve the quality of insurance and reinsurance services in Bangladesh; registration and certification of insurers, re-insurers, intermediaries and renewal, modification, withdrawal, suspension or cancellation of such registration; laying down the code of conduct and guidelines for training and instruction manuals for intermediaries, insurance and reinsurance intermediaries and agents; establishing and regulating funds for protection of policyholders;

making regulations for the insurance industry and delegation of powers with prior approval from the government; establishing the Insurance Regulatory Fund; and establishing Insurance Advisory Committee.

The Insurance Development & Regulatory Authority (IDRA) of Bangladesh recognizes a total of 77 insurance companies as authorized to operate in Bangladesh, of which 30 provide life insurance and 45 are in the general insurance field. Among the life insurance companies, except the state-owned Jiban Bima Corporation (JBC) and a foreign-owned American Life Insurance Company (ALICO), the rest are domestic private entities. Among the general insurance companies, state-owned Shadharan Bima Corporation (SBC) is the most active in the insurance sector.

Table 6.1: Performance Indicators of the Insurance Market

	2005	2010	2013
Number of Insurance Companies	62	62	66
Number of Insurance Policy Holders	3,246,108	6,703,073	17,098,364
of which: Life insurance policies	3,015,861	6,279,031	16,038,269
Non-life insurance policies	230,247	424,042	1,060,095
Number of Insurance Policies	7,689,907	15,114,084	17,968,616
of which: Life insurance policies	6,978,299	13,863,772	16,498,603
Non-life insurance policies	711,608	1,250,312	1,470,013
Insurance corporations	38,012	109,109	182,973
of which: Life insurance tech. reserves	32,641	100,985	172,050
Non-life insurance tech. reserves	5,371	8,124	10,923

Source: Financial Access Survey, IMF

Insurance premium is the major source of fund for the insurance companies. The insurance market in Bangladesh has remained very small given its relatively small asset size. However, both the assets of insurance companies and its share in the total assets of the financial system have been increasing in recent years. But this growth of assets of insurance companies was owed to the growth of the capital market as large gains from the stock market generated handsome amounts asset buildup and income growth, although not sustainable over the longer term. The share of insurance companies in the total assets of financial sector was 1.83% in 2003, which increased to 2.17% in 2011, in part backed by gains made in the stock market during the boom period.[6]

The Insurance Market is plagued by its various problems. First, there is less public awareness regarding insurance services among the vast majority of people living in rural areas who are as a result left outside the insurance coverage. People in general are not aware of the benefits from the insurance policy in Bangladesh. Second, most of the insurance companies in our country are

[6] Masuduzzaman, M., Rahman, M.H., and Ahammed, S. (2013). Integration of Financial Market and Its Implication of Stock Market Development in Bangladesh: An evaluation. Bangladesh Bank Working Paper Series: WP 130, December 2013, Bangladesh Bank: Dhaka.

located in urban areas and there are few branches in rural areas. They do not realize that majority of the population reside in rural areas and if branches are expanded to rural areas, then the business can thrive there subject to adoption of a policy to motivate the mass people in the rural areas to raise their awareness. Third, the growing cost of business is a hindrance that insurance companies are facing nowadays. The rate at which tax, house rents, utility bills, commission fees and the costs of stationeries are rising exceeds the rate at which their business is growing. Besides, the policy holders are not willing to pay too much premium with the increasing costs of living that is hampering the strategies of insurance companies. Other problems include the limited range of insurance services provided, lack of qualified officials, the very archaic methods of premium calculations adopted by the companies, the lack of training for employees, the limited use of information technology, insufficient service and the lack of marketing policy. The managements are not taking initiatives to increase their market penetration. They allocate tiny amounts of money for the advertisement purpose, which is not sufficient for increasing business development.

Going beyond the formal insurance sector, under the Seventh Plan an important agenda for the insurance sector could be to develop micro-insurance products (with certain special characteristics relating to coverage, premiums, delivery channels, terms and benefits) which are of value to the poor. The challenge would be to design micro-insurance services (e.g. micro life insurance, micro health insurance, crop insurance, livestock insurance, micro enterprise insurance) which would be risk shifting devices offered by the insurance companies/institutions especially suited to the needs of low income households in rural and urban areas and which would be affordable. At present, a group of mainstream insurance companies, MFIs and professional organizations (e.g. International Network for Alternative Financial Institutions) are offering some 'micro-insurance' products which need to be objectively evaluated in terms of effectiveness of delivery mechanisms and, as appropriate, re-designed to better serve the poor. The Seventh Plan should look upon micro-insurance as a potential means of minimizing the risk of falling below the poverty line due to a number of shocks ranging from personal disasters to various idiosyncratic shocks.

2. Recommendations

As part of reforms for the Insurance Market, Asian Development Bank (ADB) has recommended that the government implements a white paper to strengthen the insurance sector by:

(i) agreeing to a timetable for recapitalizing all the insurance companies in accordance with Insurance Act 2010;

(ii) adopting investment regulations as required by Section 41 of the Insurance Act 2010;

(iii) initiating implementation of this white paper; and

(iv) Implementation of the following regulations: (a) management of IDRA Fund and (b) CEO appointment.

Even though the draft white paper has been formulated, it has not been approved by the Cabinet as yet. However, implementation of the policy paper and insurance regulation with regard to CEO appointment and management of IDRA Fund has already been initiated.

VII. CONCLUDING OBSERVATIONS

The background paper for the Seventh FYP has provided overviews of past and recent developments in the five major markets comprising the financial sector of Bangladesh. Certainly Bangladesh financial system, despite significant progress on many fronts, is quite underdeveloped and suffers from serious institutional and regulatory weaknesses. These institutional weaknesses have undermined financial sector development (e.g., insurance sector), reduced confidence of market participants in the manner certain markets function (e.g., stock market), and contributed to increased cost of financial intermediation or mobilizing funds (e.g., banking system) for private sector investment. Fraudulent activities and market manipulations, when remain unpunished due to political and other reasons give wrong signals to market participants and encourage culture of default and manipulations increasing financing cost for all and limiting access to financing for the genuine SME borrowers.

Given the size of the background study and the kind of details provided both in terms of contexts and recommendations, the paper has discussed the recommendations for each market segment separately. This presentation, however, does not mean that interlinkages amongst the markets have not been addressed while specifying the recommendations. Relationships between bond market and stock market development issues are very clear and certainly reinforcing. In all major financial transaction in the area of infrastructure will require support from all the segments of the financial sector depending on the type of financial transactions involved and risk mitigation. Development of forward market for exchange and interest risk mitigation will help develop secondary markets for stocks and bonds and contribute to large commercial financing.

Banking sector dominates the financial system in terms of its size and private sectors' dependence on this sector for access to finance. Through several rounds of reforms since the 1990s banking sector performance had improved in terms of all indicators until 2010. However, beginning 2009, a drive for rapid business expansion and engaging in speculative activities on the part of the private sector and going for high risk investments (in terms of quality of assets and projects) in order to derive higher return on assets—supported also by easing of monetary policy of Bangladesh Bank-–burdened the corporate sector with excessive debt burden, and the banking sector with a rapid increase in non-performing loans. This dual problem of overly indebted private sector and overburdened nonperforming assets of the banking system are not going to disappear in the near term and it will take several years of concerted efforts on the part of regulator and the banking sector to grow out of this state of affairs. The recommendations presented relating to money market development, if implemented properly, will go a long way to improve the situation over time. If the government and the industry are serious about reducing cost of financial intermediation, and thereby reducing the interest rate structure, there is no single silver bullet for that. Concerted efforts in improving monitoring and governance of the financial sector must be adopted without further delay. In this regard we welcome the new financial sector reform program agreed with the World Bank to strengthen governance and initiate market deepening process.

Bangladesh capital market has gone through two major round of boom and burst in the last two decades. The most recent one was during 2009-11. This type of market instability indicates weak governance structure, narrow institutional investor base, half- or uneducated large small investor base, weak capacity of SEC to monitor market developments at the micro level and act timely and decisively, lack of coordination among important regulators (including with Bangladesh Bank and Ministry of Finance), and lack of capacity on the part of the regulator to withstand political pressures. The fact that no noticeable action was taken against the perceived market manipulators in both rounds of market meltdown, has eroded confidence of market participants in the capital market itself.

On the positive side, with support from ADB, a number of very important reforms have been initiated by SEC and the government with a view to prevent similar market manipulation in future. Demutualization of stock exchanges, strengthening of SEC's capacity to enhance surveillance, and numerous other initiatives would certainly help restore market confidence. However, it would be important that the Government enacts the new draft FRA act through Parliament despite opposition from some vested quarters. A number of other recommendations have been made in the report including on issues relating to: operations of primary and secondary markets; better policy coordination among key regulators; improvements in trading, clearance and settlement systems; development of institutional investor base; and improving financial literacy among small investors.

The third important pillar of the financial system in any country is the bond market. However, in Bangladesh the bond market is most underdeveloped and lacks clear direction and initiatives from the government about its future development. Like in any country, government bond has to play the "market maker" role in the development of the bond market. But the very traditional way of looking at government bonds as only the source of budget financing and at an artificially depressed rate for treasury bills have undermined development of the secondary market for government bonds. The primitive manner in which medium-term bonds (up to 5 years) are issues and managed by the Directorate of National Savings, without allowing any secondary market to develop, has not served bond market development. The absence a vibrant insurance and pension Fund sectors have also undermined demand side of long-term bond market development. Development of municipal bond market could be another important new area that the Government should look at in terms of fostering local level infrastructure development by the urban/city based local governments themselves.

Bangladesh's financial sector would need to play an important role in achieving the economic and social development objectives of the Seventh FYP and it is understood that the developing the financial system is a long term process. Given the range of issues confronting each important segment of the financial sector, separate sets of recommendations have been made for all financial sector components. The government in collaboration with the relevant regulatory agencies (such as Bangladesh Bank, Security and Exchange Commission of Bangladesh, IDRA) should be able to implement most of these recommendations during the Seventh Plan period in consultation with private sector stakeholders. Technical support from international development and financial institutions like the World Bank and IMF (as in the case of the banking system), Asian Development Bank (as in the case of stock market and insurance sector reforms) and others may be helpful in implementing the reform agenda.

The money market in Bangladesh—anchored by the banking system despite numerous problems of its own--is well ahead of other components of the financial system. The banking system is plagued by governance problem leading to rapid accumulation of nonperforming assets. The problem is most acute in SCBs and the remedial measures need to be implemented urgently. The capital, bond and insurance markets are relatively small and in many respects underdeveloped relative to other comparator countries. The government is already in the process of implementing a comprehensive capital market reform strategy with support from ADB and this reform agenda, as describe in the list of recommendations, should be completed within the first half of the Seventh Plan. Strategic priority should be given to the development of the Bond and Insurance market in the reform agenda for the Seventh Five Year Plan. The Insurance Market should be developed as a medium term strategy in order also to help develop the bond market in the long term.

On the economic side, facilitating private sector investment and promoting domestic/national saving to finance the investment requirements, while ensuring continued financial stability, will be the major challenge. Since the higher growth target envisaged under the Plan would require a commensurate increase in the investment/GDP ratio, mobilization of foreign financing will also be very important in filling the domestic investment-savings gap. At the same time, the sharply higher domestic private investment that would be required to meet the Plan objectives would call for a market based reduction in the interest rate structure and a reinvigorated stock market. A sustained reduction in the interest rate structure will require enhanced efficiency of the banking sector, a sharp improvement in the quality of bank loans, and sustained reduction of inflation to less than 5% level, and also a reduction of the very high corporate tax rate on banks.

On the social side, the two main challenges of the Seventh Five Year Plan is that the financial sector reforms need to emphasize the issue that financial market developments need to follow certain norms to ensure inclusive economic growth and poverty reduction. Addressing moral hazards arising from the rapidly deteriorating culture of nonperforming loans by large defaulters need to be addressed to ensure social equity and justice. While bringing down the interest rate structure, the average deposit rate should not be allowed to become to become negative.

Financial repression through negative real interest rates would undermine domestic savings and would be socially inequitable. The agenda for financial inclusion must be pursued strongly by providing financial services needed by the relevant economic agents, especially the poor and disadvantaged groups, in order to expand their socioeconomic opportunities and also achieve further development of the financial sector.

The reform agenda for the financial sector is quite heavy and challenging. All related regulators (Bangladesh Bank, SEC, IDRA and the Ministry of Finance) and the government as a whole must work together to restore the overall health of the financial sector and simultaneously carry forward the reform agenda to enable the financial sector to play its legitimate and important role in the economic development of Bangladesh.

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