

## Bangladesh Survey: Issues in Local Bond Market Development

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Like emerging-market countries around the world, Bangladesh could benefit from having a local-currency, fixed-income securities market. At present, its main fixed-income financial products are bank deposits, bank loans, government savings certificates, term loans, treasury bills, and government bonds and corporate debt (syndicated loans, private placement, and debentures). But in general the corporate debt market is still very small compared with the equity market (see table 1).

**Table 1. Instruments Available in Bangladesh**

Nominal amount (billions of takas)	Relative size (%)	Instruments
474	31.9	Bank Loans
580	39.1	Deposits
184	12.4	Term loans (as of June 1998)
123	8.2	Government saving certificates
55	3.7	Government bonds
40	2.6	Treasury bills
27	1.8	Equity (issued value)
(Not publicly available)	Private placement	
1.3	0.1	Debentures

Sources: Bangladesh Bank, National Savings Bureau, Dhaka Stock Exchange.

Numerous factors in Bangladesh today suggest that Bangladesh will not be able to develop an active, local-currency fixed-income market. Economic and financial transactions are highly regulated, and the economy does not provide a sufficient number of appropriately structured and skilled issuers and investors. Although the government recently began privatizing selected state-owned companies and deregulating the financial market, progress has been slow, leaving financial market participants skeptical about whether the government can succeed in this endeavor.

Bangladesh finds it difficult to move forward for several reasons: weak governance at the institutional and market levels; high nonperforming assets among the nationalized commercial banks (NCBs); poorly defined and overlapping responsibilities of the Bangladesh Bank, Securities and Exchange Commission, and Ministry of Finance; and the lack of incentives and private initiative to drive market developments.

These four problems are the principal obstacles to the development of bond markets in Bangladesh. The government is aware of them, and the World Bank and other organizations have been pushing for solutions. However, change is slow.

Although there is no meaningful base for a secondary market in corporate bonds today, the Bangladesh economy may well grow at an attractive rate in the future, and if it does, capital-intensive industries such as gas and telecom will invest heavily. Thus Bangladesh will eventually need an efficient capital market that can mobilize domestic and foreign resources for investment. For the time being, however, Bangladesh should focus on creating a well-organized, regulated, and attractive primary market in both public and private placements. This discussion is about some of the impediments to the development of fixed-income market in Bangladesh and some ways to remove them.

## MAJOR IMPEDIMENTS TO BOND MARKET DEVELOPMENT

The obstacles to bond market development can be divided into three broad categories: those around and across the market, and those inside the fixed-income markets.

## Around and Across the Market

The obstacles in this group stem from the political situation, the macroeconomic situation, and the broader financial system.

*The Political Situation.* The People's Republic of Bangladesh has been a parliamentary democracy since September 1991. The present government is headed by the Awami League which has an absolute majority, but the opposition party has stepped up its nationwide program of strikes, processions, and mass meetings. These activities have weakened the government's intentions to foster changes such as the development of the financial market.

In addition, certain commercial and financial regulations are outdated in that they tend to focus on institutions rather than functions. Governance and accountability are lacking in certain areas, and there are elements of inefficiency in the financial system, mainly concerning the state-owned banking sector. Although the government is aware of these problems, it has been slow to improve governance and develop strong institutional capacity. The problems created by these weak institutions are compounded by an increasingly confrontational political environment.

At the same time, the government has committed itself to launching financial reforms that could help accelerate the country's rate of growth. The main goal of these reforms is to reduce the direct controls on the financial system, and to deregulate and introduce a new set of market-oriented approaches to financial sector activity. The Bangladesh National Budget for 1999–2000, for example, earmarks funds for the creation of a central depository system (CDS) to help streamline trading at the stock exchanges and improve authentication. Furthermore, a proposal is under scrutiny that would amend the Trust Act to allow provident and pensions funds to invest in the capital market. To achieve that goal, it will be essential to ease the bad-loan situation, which is draining the country of its monetary resources. But certain factions in Bangladesh oppose those aims and commitments. Since no one has stepped forward to "champion reform," the government appears unwilling and unable to undertake the requisite changes in due time. Because the political environment is so fragile, laws and regulations are not being fully enforced.

***Macroeconomic Situation.*** Bangladesh's macroeconomy was fairly strong throughout the 1990s, with growth rates averaging a respectable 5%, and inflation averaging a modest 9%–10%. The primary fiscal deficit during the past five years has averaged about 5.5% of GDP, which has generally been within sustainable limits. (However, the consolidated public sector deficit, taking into account losses incurred by state-owned enterprises, is much higher and underscores the need for improved fiscal management, although foreign exchange reserves have become more stable recently owing to impressive export performance and reduced imports.) Heightened foreign investor interest in the country's natural gas sector has opened up tremendous possibilities.

But despite these positive elements there are some serious constraints on the development of active corporate bond markets in Bangladesh. First, Bangladesh is one of the poorest countries in the world, with approximately 125 million inhabitants, of which about 60 million live below the poverty line. Although its GNP growth rates—in the range of 4%–5% year—are attractive, they suggest that it will take Bangladesh 25 years to double its per capita income. In order to reduce the incidence of poverty to about 11%, as it hopes to do, Bangladesh will have to achieve economic growth rates of 7.5% or more a year. According to several studies (see, for example, World Bank, “Bangladesh, Key Challenges for the Next Millennium,” April 1999), economy has the capacity to move out of poverty with increasing speed, but that will require decisive policy actions in several areas, not least of which is the financial market.

However, a sense of urgency is missing in policymaking, despite the growing imbalances in the economy and crowding out as Bangladesh continues to channel vast monetary resources into servicing bad loans. Given that macroeconomic changes can happen in short periods of time and that nonperforming loans, which account for a third of the loan portfolio, can create financial sector vulnerability, the bad-loan situation could trigger a severe liquidity crisis nationwide. It can take decades to build a fixed-income market in the wake of such crises. This issue clearly needs immediate and focused attention.

If the country's positive macroeconomic trends continue into the future, the fiscal deficit and bad-loan situation will ease up and these factors would pose less threat to the financial market.

***Broader Laws and Regulations.*** Certain omissions or drawbacks of the broader laws and regulations directly affect development of the fixed-income market. First, with regard to the ownership of land, the law provides for the registration of deeds rather than of ownership, which makes it impossible to take land as collateral for bond issuance. Second, the law makes arbitration a cumbersome and slow process; moreover, foreign arbitration awards are not enforceable in Bangladesh. Third, in terms of obtaining issuers, there is no privatization law to lend transparency and authority to the privatization process, although one is at present being drafted. Fourth, Bangladesh's laws represent a mixture of codified British common law and legal principles from various religious heritages. Although the court system derives from a common law tradition, Bangladesh courts are limited in their ability to function effectively.

In view of these constraints, the legal system can move only so fast in amending the laws and enacting new ones, even though the government acknowledges the need for such changes. Contract laws and commercial codes seem to be fair, but ensuring that they are observed is difficult because of a weak adjudication system.

***Broader Financial System.*** The broader financial system includes the banking sector, nonbanking sector, government securities market, and short-term money markets.

***Banking sector.*** Bangladesh's banking system, which is dominated by state-owned NCBs, creates two serious problems for a local corporate bond market.<sup>1</sup> First, the system provides low-cost loans to state-owned enterprises, which account for a large part of the corporate sector. This undermines development of the corporate bond market because other financial institutions are unable to compete with these "underpriced loans." Indeed, the state-owned enterprises constitute a large part of the NCBs' business. To complicate matters, development financial institutions (DFIs) also provide low-cost loans, priced at a small percentage over bank deposits for similar maturities.

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<sup>1</sup> The Bangladesh banking sector is composed of the central bank (Bangladesh Bank), 4 state-owned commercial banks, 4 specialized banks, 13 local private banks, and 12 local foreign banks.

Second, the banking sector is faced with a substantial number of bad loans; nonperforming assets account for about 30% of total assets. Although these nonperforming assets can be said to create a need for an active bond market, to the extent that banks are constrained in new lending and thereby cannot meet the funding needs of corporate borrowers, they also rob the bond market of needed investors. Yet the state-owned banks just keep on making bad loans.

*Nonbanking sector:* The nonbanking portion of the financial sector consists of two small stock exchanges (Dhaka and Chittagong),<sup>2</sup> both of which have still not recovered from the bull market problems of 1996, which left the public suspicious of corporate institutions because it is hard to get them to disclose their figures. At that time, the stock exchange experienced a hefty run-up in prices owing to a large inflow of funds from retail investors. This inflow, drawn by the prospect of easy money, was a new experience for the Bangladesh people, but it lasted only the second half of 1996. In those six months the index soared from 500 to 3500 and the market came crashing down to about 600. The stock market has not recovered yet: in May 1999 the index hit a 63-month low, at about 465. The average daily turnover in the spring of 1999 was about US\$1 million to US\$2 million. The weak operating performance by listed companies and low confidence in the market overall has made it difficult for the market to recover.

In sum, the nonbanking sector has not evolved in a way that would allow it to play an active role in the financial system. Nor, as discussed in the section on intermediaries, is it prepared to play an

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<sup>2</sup> The nonbank section is made up of 2 stock exchanges (Dhaka and Chittagong), 170 active brokerage firms, 19 nonbanking financial institutions, and 17 merchant banks.

The Dhaka Stock Exchange (as of April 1999) has 208 listed companies on the equity side, 9 mutual funds (of which 8 are issued by the Investment Corporation of Bangladesh, ICB), a state-owned mutual fund company, 11 debentures, and a total market capitalization of approximately US\$1.1 billion, of which equity stands for approximately US\$1 billion. The Chittagong Stock Exchange has 136 equity shares listed, 9 mutual funds, 5 debentures, and a market capitalization of about US\$825 million. Membership is open to foreigners at the stock exchanges. Trading is done through an automated real time system and settlement occurs on T + 5.

active and skilled leadership role in developing and participating in an active fixed income market.

*Government securities market.* The government securities market in Bangladesh is small, does not provide much of a yield curve to support a corporate bond market, and does not provide intermediaries with skills and a profit base to support the corporate bond market. At present, the government issues long-term savings certificates at high interest rates and government bonds, and it only has market-oriented rates for T-bills.

At the shorter end of the market, T-bills are auctioned weekly for 91 days and the Bangladesh Bank (BB) occasionally issues paper for 180 days, 365 days, and 720 days. Commercial banks participate in auctions weekly for 91-day T-bills, whereas the others are issued occasionally. Accepted bids are noted in the newspapers. The market is small, with outstandings of about US\$800 million. There is no secondary market and no market for repurchase agreements (“repos”). T-bills are transferable, but settlement is manual and very slow, done through BB. On the whole, T-bills are mainly used to satisfy statutory liquidity requirements (SLRs). The past few years have seen a clear bias for short-term borrowing.

Government bonds, with maturities ranging from 3 to 25 years, are issued when needed; they do not create a yield curve as T-bonds are nontransferable, mostly because they are issued to recapitalize state-owned banks. Their notable feature is that they are guaranteed by the government and are eligible for SLRs.

Government savings certificates (GSCs) range in maturity from three to eight years. GSCs are offered to different types of investors in the retail sector (but small corporates are allowed to invest). The types of investors are mostly individuals and families but also include charity and provident funds. GSCs are issued in series through the year. The holder may redeem them at par at any time.

Finally, GSC issuances offer significantly higher rates than local bank deposits, which create a relatively high rate for risk-free and tax-free government securities. This establishes a high benchmark rate for corporate fixed-income securities, creating a disincentive to invest in corporate securities. GSC rates are 2%–3% higher after tax compared with rates on other government paper. GSCs create a

high benchmark interest rate foundation for corporate securities. That matters because it is very hard to compete with risk-free government debt.

At present, Bangladesh law and the government's fiscal and monetary policy combine to create a financial market monopoly for GSCs and NCBs, which in turn keeps alternate financial intermediation from emerging. Bangladesh needs a healthy nonbank financial institution (*NBFI*) sector to increase mobilization and make competitive financing available in a fixed-income market. To achieve that end, it must break the NCBs' monopoly. Although the government is aware of this problem and has put forward some relevant reforms, there are no real incentives to speed up the process, maybe because of political considerations.

*Short-term money markets.* Money markets provide another foundation for bond markets. The money markets in Bangladesh are quite small. *There is* an interbank market, in which commercial banks borrow and lend to adjust their short positions (the size of this market is not publicly known). Normal maturities range from overnight to 30 days. Bangladesh also has a forward market for U.S. dollars against the taka, but only for short maturities. There is no commercial paper market.

### **Inside the Fixed-Income Markets**

The important factors to consider inside the fixed-income markets are regulators and regulations, central market infrastructure, and intermediaries.

*Regulators and Regulations.* One impediment at the regulator and regulation level is the overlapping authority between the two financial market regulators, Bangladesh Bank and the Securities and Exchange Commission (SEC), and no clear jurisdiction over the fixed-income market. In general, BB regulates the commercial banks and their activities, while the SEC regulates the NBFIs, the two stock exchanges, and the capital market.

A second problem is that the SEC has no authority to issue rules and regulations, and the procedure as a whole is long and drawn

out. As a result, the SEC has not proposed any regulations for the issuance of bonds or debentures. All rule proposals must first be submitted to the Minister of Finance for approval and then passed on for approval from Ministry of Law. Furthermore, potential issuers have to look at various sets of regulations and follow a long and cumbersome procedure.

Third, although the SEC requires listed companies to meet international standards on accounting and auditing, accounting information appears to be of doubtful quality and reliability.

Fourth, the Securities and Exchange Act of 1993 confers vast regulatory authority on the state, and is regarded as a constraint on capital market development. There is a board of policymakers. Three of its members are appointed by the state, another is from the Ministry of Finance and one from the central bank, and the chairman is appointed by the government.

Fifth, in the present system, a company can float debentures up to a maximum amount of its current asset value and has to register its assets in the name of the Trustee as Security. Hence there is no provision for floating unsecured debentures.

***Central Market Infrastructure.*** In the absence of a secondary market in fixed-income securities, no effort has been made to build up a central market infrastructure to support it. Bangladesh only has a telephone market for T-bill trading and central market infrastructure at the stock exchange for trading equities and debentures. In the T-bill market, the counterparts call each other and settle transactions without any transparency in real time for other participants in the market. At the stock exchange, the debenture market is fully automated. The debenture market has a somewhat more transparent order-matching system in that bids and offers are entered in the computer and then matched automatically.

Bangladesh has no central depository system, though one is expected to start operating in 2000. Today, clearing and settlement are done manually, which creates various risks to completing a transaction. Also lacking are a credit rating agency, research and information companies, and market information on screens; market participants are referred to other media, such as the daily financial newspaper, and thus experience a delay in obtaining essential eco-

conomic information. According to some participants, even that information is often unreliable.

***Market Participants.*** Market participants can be divided into issuers, investors, and intermediaries.

***Issuers.*** The foremost impediment here is that Bangladesh lacks a significant number of potential, good-quality issuers. Its economy continues to be agriculturally based; agriculture accounts for nearly 30% of the country's GNP, and more than 70% of the labor force is engaged in agricultural activities. The industry and service sectors contribute 20% and 50%, respectively, but compared with landholdings, the average size of industrial and commercial enterprises is rather modest.

Most private sector enterprises are small and owner-run, many are of "cottage size" and most are in the garment industry, which to date depends largely on short-term bank loans for financing. These enterprises could benefit from longer-term funding but are neither large enough nor well known enough to issue bonds. Most of the large-scale industrial units and commercial enterprises are state owned. Their shares are not listed, and they do not offer debentures since their financing needs are met by the government or by the state-owned NCBs. These state-owned firms generally stay outside the capital market. The privatization program for state-owned companies works too slow to influence the market.

Second, although Bangladesh has a debenture market, to date only a small number of well-known issuers have used the market (see table 2). The liquidity in those debentures at the stock exchange is insignificant because of the small number of investors and their buy-and-hold mentality. The investor community does not seem to find this market too attractive owing to weak disclosure by the issuers, which in turn reduces credibility and investor confidence.

Third, companies find that issuing debt is costly, both in monetary and nonmonetary terms. The interest rate distortion due to the GSCs mentioned earlier raises the ongoing cost of borrowing, while various up-front costs amount to about 7% of the value of the issue (these include registration costs—that is, stamp duties—totaling about 2.5% of the issue value).

**Table 2. Prominent Issuers in the Debenture Market**

Debenture	Coupon	Year of flotation	Issued debenture (in millions of taka) <sup>a</sup>
Beximco Infusion Ltd.	17	1992	14.5
Beximco Synthetics Ltd.	14	1993	240.8
Bangladesh Chemical Industries Ltd.	17	1993	3.2
Eastern Housing Ltd.	15	1994	202.5
Beximco Knitting Ltd.	14	1994	188.4
Beximco Fisheries Ltd.	14	1994	94.3
Beximco Textile Ltd.	14	1995	222.8
B.D. Zipper Ind. Ltd.	14	1995	22.4
Beximco Denim Ltd.	14	1995	278.5
Bangladesh Luggage Ind.	14	1996	135.0
Arami Cement Ltd.	14	1998a	112.5

<sup>a</sup> No debentures were issued in 1997.

Fourth, it is difficult to persuade issuers to disclose sufficient information about their companies (although prospectus requirements for listed debentures do seem fair).

Yet another problem is that most potential issuers are unwilling to take the opportunity cost involved in issuing a long-term bond. In addition, the absence of a yield curve makes pricing difficult.

*Investors.* On the investor side, few investors are sophisticated enough to think about investing in bonds. About 80% of the base here is made up of retail investors, whose primary concerns include the equity at the stock exchange or the government savings certificate.

Of the few institutional investors that could support a bond market, most are either prevented from investing in corporate bonds by restrictive guidelines or are not professionally managed. The major institutional investors are the Investment Corporation of Bangladesh—a government-owned financial institution—and the insurance companies. The mutual fund industry in Bangladesh is the exclusive domain of ICB. There are no private mutual funds to mobilize savings toward the debt market, and the ICB's monopoly has prevented new investor companies, that is, mutual funds, from developing in Bangladesh. There are provident and pension funds (total assets managed amount to Tk 6.7 billion; see *The Financial Express*), self-managed by public and private corporate entities, but none are professionally managed. The pension obligations of the gov-

ernment are not funded. The Trust Act of 1882 prohibits those funds from being invested in equities, corporate debentures, and private money market instruments.

In addition, no protective laws are in effect to ensure that investors will get their dividend and capital back. Missing are higher audit standards together with SEC regulations on disclosure standards in prospectus along with arbitrary institutions.

Furthermore, most investors lack a trading mentality and just buy and hold because of SLR requirements or because they do not know how to trade.

Few foreign investors are attracted to this, mainly because of the weak disclosure by the borrowers. As for the general public, it has little understanding of debt products, and the intermediaries are not much help because few engage in research on markets, companies, and industries to encourage investment.

*Intermediaries.* Intermediaries in Bangladesh lack many of the skills needed to foster an active local corporate bond market. As mentioned earlier, commercial banks dominate the financial sector and not enough intermediaries are skilled in securities. Few are able to identify issuers and investors and bring them to the market. They provide little or no research analysis on industries or companies to encourage investment in the local debt market. Too few private merchant banks are able to conduct financial advisory and trust services. Nor do any feel motivated to become a market maker for an issue. Hence the market is illiquid, with large spreads. At the same time, the fee structure and pricing are high enough to allow intermediaries to make money, but because transactions are so limited, the intermediaries seldom make money. Even if they are able to participate, intermediaries are reluctant to take any risk in dealing.

## RECOMMENDATIONS ON HOW TO REMOVE THE IMPEDIMENTS

The various impediments to bond markets in Bangladesh pose a large challenge for policymakers. Nevertheless, some suggestions can be made for dealing with them.

Overall, given the current situation in Bangladesh, the country should focus on developing a well-run primary market, both for private placements and for public offerings. That means several steps need to be taken to fix the inside elements of the market, in addition to some changes around and across the financial system.

### **Inside the Market**

***Rules, Regulations, and Regulators.*** The role of the BB and SEC in regulating the fixed-income market needs to be clearly defined in detail so that appropriate regulations can be written for the public, private, and secondary markets. These regulations should ensure that each market is encouraged and protected. In view of situations around the world, it likely is best to have the SEC regulate the fixed-income market. But whichever agency is chosen, the regulator must be educated appropriately to ensure that it fully understands the product and is able to supervise the markets, monitor the risks in the markets and the intermediaries, and enforce its power where necessary to ensure a quality market.

***Central Market Infrastructure.*** Bangladesh should consider whether to develop a central clearing, settlement, and depository institution. Such an entity would support both the equity and debt markets.

***Market Participants.*** There are too few professional participants in the Bangladesh market to create an effective secondary market in fixed-income instruments. Activities in the market are as yet too limited because the government is unable to create an effective yield curve. When such a base is established, market participants will know their relative value for issuing and investing, which in turn will attract new participants to the market.

The government also needs to support private initiatives to bring intermediaries to the marketplace. They, in turn, bring the trading mentality to the market that is essential for a secondary market. The best way to do this is to create incentives for professional people to establish their own profitable business. With such a base, the market will drive itself and private initiatives will ensure diversity in fixed-income instruments. To build investor confidence, the market

needs strong accounting rules and regulations comparable to international standards. To that end, the government should strengthen and supervise the accounting rules and controlling body.

### **Factors Around the Market**

*Macroeconomic.* At a more general level, to foster market development, Bangladesh needs to bring more competition into the financial sector through deregulation and privatization. The *country* appears to be moving in that direction, but the speed is slow. The government needs to accelerate its efforts in this area.

*Broader Financial System.* Ideally, there are several ways that Bangladesh might work to improve operations in its government securities market, to create a market that provides an interest rate structure that supports the entire financial system and a benchmark for corporate bond offerings. However, the analysis performed for this study was not sufficient to determine whether and if so when certain changes might best be suited for Bangladesh. But some suggestions can be made which Bangladesh might consider over time, as it seeks to improve operation of its government securities market.

More specifically, instead of issuing tax-free and nontransferable government bonds to the retail market, the government should consider issuing its bonds in the marketplace. It might issue T-bills and T-bonds with a broader maturity base, transparent pricing, which are tax-neutral and transferable. To start with, efforts might focus on building an effective money market (O/N–365 days), and from that base it may be possible over time to create new short-term instruments such as repos, futures, short-term interest rate swaps, commercial paper, and a USD/Taka forward market. It is important to build a more sophisticated interbank deposit market with different maturities. This will help create the everyday price fixing needed to price other financial products (for example, leasing agreements), and it can help create a forward rate agreement (FRA) market. Creating an effective yield curve will help provide a foundation for ultimately creating a diverse secondary market.