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FINANCIAL SECTOR

AN AGENDA FOR FURTHER REFORMS

Asian Development Bank

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Syed Ali-Mumtaz H. Shah

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Currency Equivalents

(as of 6 February 2009)

Currency Unit	–	taka (Tk)
Tk1.00	=	$0.014
$1.00	=	Tk68.940

Abbreviations

ADB	–	Asian Development Bank
CBSF	–	Credit, Bridge and Standby Facility
CSE	–	Chittagong Stock Exchange
DFI	–	development finance institution
DFID	–	Department for International Development of the United Kingdom
DSE	–	Dhaka Stock Exchange
FIRST	–	Financial Sector Reform and Strengthening Initiative
GDP	–	gross domestic product
ICB	–	Investment Corporation of Bangladesh
IFC	–	International Finance Corporation
IMF	–	International Monetary Fund
IPO	–	initial public offering
NBFI	–	nonbank financial institution
NGO	–	nongovernment organization
NPL	–	nonperforming loan
OCCI	–	Office of the Chief Controller of Insurance
PCB	–	private commercial bank
SCB	–	state-owned commercial bank
SEC	–	Securities and Exchange Commission
SMEs	–	small and medium-sized enterprises
SOE	–	state-owned enterprise
UNDP	–	United Nations Development Programme

NOTES

(i) The fiscal year (FY) of the government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2007 ends on 30 June 2007.

(ii) In this report, “$” refers to US dollars.

Introduction

The economy of Bangladesh has been growing steadily. Real gross domestic product (GDP) grew at an average rate of 5.8% per annum during 2000–2009, compared with 5.5% in 1995–2009. The GDP annual growth rate reached 5.9% in FY2009, down from 6.2% in FY2008. The deep and prolonged recession in the United States and Europe from the 2008 financial crisis adversely affected GDP growth in FY2009 (see discussion under Macroeconomics Environment).[1] From 1991 to 2005, the national poverty incidence fell from 59% to 40%. Efforts to overcome poverty face numerous constraints, including the urgent need for strong law and order, good infrastructure, sound and efficient financial markets, high-quality social services that are accessible and affordable, and an enabling environment for private sector development.

The government's National Poverty Reduction Strategy[2] reaffirms that poverty reduction and accelerating the pace of social development are Bangladesh's most important long-term strategic goals. The development of the financial sector is critical for meeting the twin goals of economic growth and poverty reduction since the financial sector mobilizes resources and allocates them to those investments that are capable of generating the highest return on capital. The better the financial sector can fulfill this role, the better the economy will perform in the long run. Financial sector development can benefit the poor by: (i) promoting overall economic growth, which in turn leads to improved income levels overall, and (ii) reducing the risk of financial crises, whose adjustment costs are most felt by the poor improving access of the poor to financial services.

In recognition of the strategic importance of the financial sector in reducing poverty, the Financial Sector Strategy study for Bangladesh has been prepared to take stock of and map the required initiatives over the medium to long term. The study will guide future operations of the Asian Development Bank (ADB) in this sector in the context of the overarching poverty reduction objective of the government and ADB. The study provides an assessment of how the financial sector can help create a better environment for growth, employment, and investment and help reduce poverty. It also takes into account the political realities and identifies reforms and measures that have not yet been addressed.

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1 The 2007 subprime mortgage crisis in the United States (US) led to a worldwide financial crisis in late 2008. Economic slowdown from the developed world is likely to extend well into 2010. The deep and prolonged recession in the US and Europe affected Bangladesh's exports, foreign direct investment inflow, and overseas workers' remittances.

2 General Economics Division, Planning Commission. 2008. *Moving Ahead: National Strategy for Accelerated Poverty Reduction II (FY2009–2011)*. Dhaka: Government of Bangladesh.

Macroeconomic Environment

Rapid economic growth has underpinned poverty reduction efforts. Real annual GDP growth averaged 5.8% during 2000–2009, up from 4.8% in the 1990s and 3.5% in the 1980s. The poor have benefited from economic growth as rural and urban poverty have declined. The stable macroeconomic environment and measures taken to open up the economy resulted in annual export growth of 17% in the 3 years up to FY2008, and substantial employment generation, especially in ready-made garments. Bangladesh's economy exhibited resilience in the face of the global economic downturn as GDP grew by 5.9% in FY2009. The GDP growth rate in FY2009 revealed moderation in aggregate demand due to a slowdown in exports and remittance inflows and also underpinned by private consumption (about 75% of GDP) which rose by 6%. Exports rose by 10.3% in FY2009 despite the global financial crisis. Although growth in remittances slowed, inflows from that source still climbed by 22.4% to $9.7 billion in FY2009, which has reached the rural poor and helped finance the purchase of land and agricultural inputs. Furthermore, investment in irrigation, research, and extension, together with more liberal agriculture input and output markets, triggered a rise in productivity, especially in rice cultivation and fisheries.

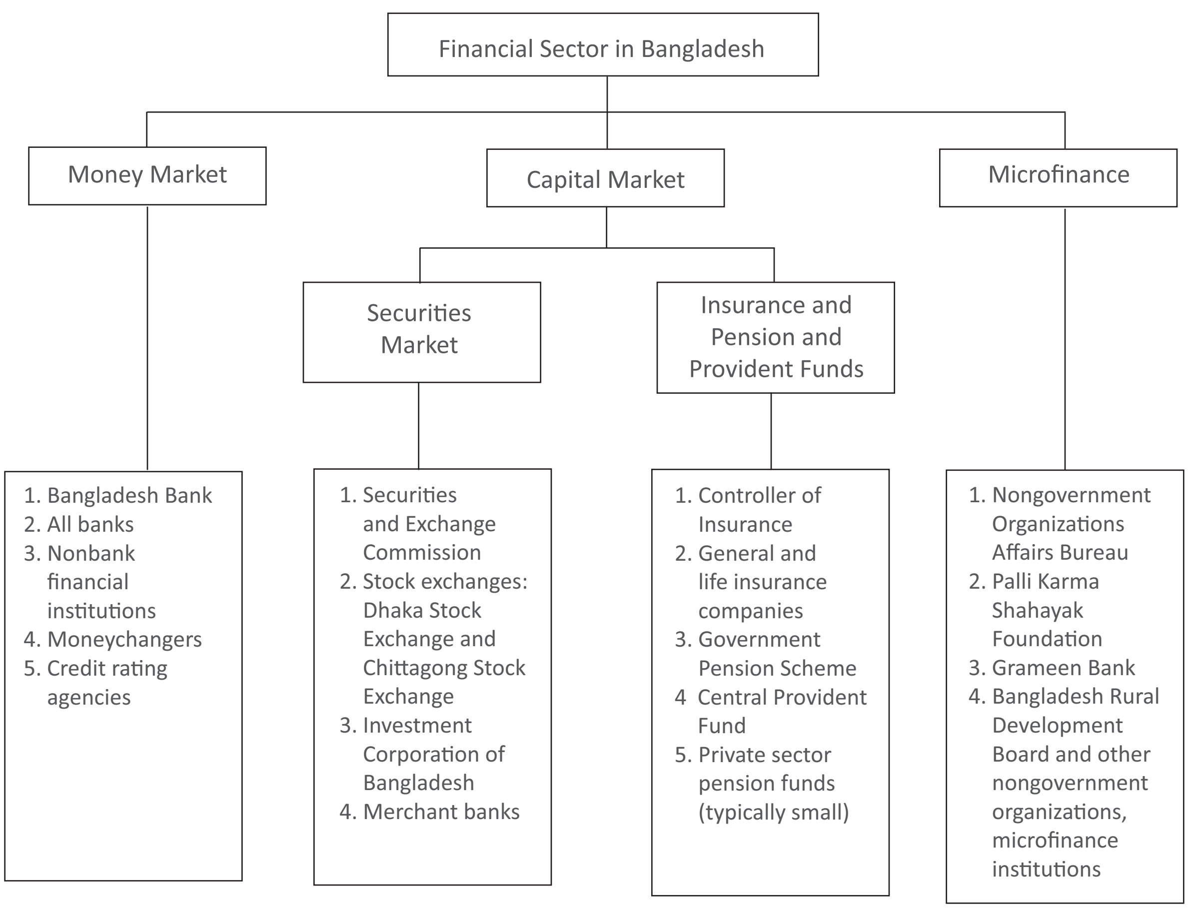
Prospects for FY2010 will depend on some key assumptions. It is assumed that political stability will prevail, and that the Government will be able to move forward in fulfilling its development priorities, sustain its focus on prudent macroeconomic management, and deepen economic reforms. It is also assumed that the measures outlined in the FY2010 budget to accelerate annual development program utilization (streamlining project approval processes and raising institutional capacities in key line ministries) will be implemented, and that the private sector will invest more in infrastructure through the new public–private partnership scheme. It is further assumed that the Government will be able to mobilize adequate external assistance and improve revenue mobilization, and avoid crowding out the private sector through excessive bank borrowing. Growth projections also assume normal weather conditions.

Against this background, GDP growth is forecast at 5.2% in FY2010 as the global economic slowdown persists, with continued moderation in external and domestic demand.

The Financial Sector in Bangladesh

Background. The financial sector in Bangladesh comprises the money and capital markets, insurance and pensions, and microfinance. In addition to the Bangladesh Bank—the central bank of Bangladesh—there are 4 state-owned commercial banks (SCBs), 5 state-owned specialized banks, 30 domestic private commercial banks (PCBs), 9 foreign commercial banks, and 29 nonbank financial institutions (NBFIs) as of 2008.[3] Figure 1 depicts the nature of the financial sector in Bangladesh.

Figure 1: Financial Sector in Bangladesh



Source: Policy Analysis Unit, Bangladesh Bank.

[3] As indicated on the website of the Bangladesh Bank: www.bangladesh-bank.org/fnansys/fnansys.html

While the Bangladesh Bank has regulatory and supervisory jurisdiction over the entire banking subsector as well as the NBFIs, the Securities and Exchange Commission (SEC) exercises similar functions for the stock exchanges and the merchant banks. Most of the institutions in the financial sector are characterized by a mix of public and private ownership. For example, in the banking subsector, as of September 2008, there were 4 SCBs, 5 government-owned specialized banks dedicated to agricultural and industrial lending, 30 domestic PCBs, and 9 foreign commercial banks. The specialized banks are often called development finance institutions (DFIs). Out of the five specialized banks (enjoying 10% of the total industry's assets), the Bangladesh Krishi Bank and Rajshahi Krishi Unnayan Bank were created to meet the credit needs of the agriculture sector, while the Bangladesh Shilpa Bank and Bangladesh Shilpa Rin Sangstha were set up to extend term loans to industry.

Of the 29 NBFIs, 1 is government owned, 15 are local (private), and the other 13 were established as joint ventures with foreign participation. The total value of loans and leases granted by these institutions is Tk99.1 billion as of 31 December 2007. The Office of the Chief Controller of Insurance (OCCI) has supervision authority over the insurance industry. General insurance is provided by 21 companies and life insurance is provided by 6 companies. The industry is dominated by the two large, state-owned companies—the Sadharan Bima Corporation for general insurance and the Jiban Bima Corporation for life insurance—which together command most of the total assets of the insurance subsector. Microfinance institutions grew rapidly and microcredit programs in Bangladesh are implemented by various formal financial institutions (SCBs and specialized banks), specialized government organizations, and nongovernment organizations (NGOs). The Government of Bangladesh enacted the Microcredit Regulatory Authority Act 2006 on 16 July 2006 to improve transparency and accountability in the activities of the country's microfinance institutions. The Microcredit Regulatory Authority has been established to implement the act and to bring the microcredit subsector under a full-fledged regulatory framework.

To evaluate the Bangladesh financial sector from a regional perspective, the combined share of banking and insurance in the country's GDP stayed in the 1.5%–1.6% range during FY2002–FY2006, while in India this was the case in the late 1960s and early 1970s. The Indian share during FY2002–FY2005 averaged 6.6%, or over four times that of Bangladesh. On the level of financial deepening, as measured by the rate of monetization of the economy, the broad money (M2) to GDP ratio in Bangladesh stood at 45.3% for FY2007, compared to 24.5% for India and 39.2% for Sri Lanka in the same period. In terms of stock market capitalization, the market capitalization of the Dhaka Stock Exchange (DSE) stood at 17.8% of GDP at the end of FY2008,[4] compared with 60.0% for the Mumbai Stock Exchange, 35.9% for the Karachi Stock Exchange, and 23.9% for the Colombo Stock Exchange. Market capitalization of DSE rose by 36.1% during FY2009 to reach $19 billion in June 2009 (or over 21% of GDP), reflecting the listing of companies and declaration of bonus shares in lieu of cash dividends. The development of the insurance subsector is comparable to that of Pakistan, but it lags behind both Sri Lanka and India by a considerable margin. The total premium income to GDP of Bangladesh reached a mere 0.6% in 2004, compared with 0.7% in Pakistan, 3.1% in India, and 1.6% in Sri Lanka.

Overview of recent key developments. The government launched a financial sector reform program in 1990. The program pursued a series of legal, policy, and institutional reforms to improve the process of financial intermediation, as well as to ensure more efficient allocation of financial resources and to improve the competitiveness of the private sector, thereby promoting investment and growth in the real sector. The thrust of the reform program is to improve the regulatory and governance environment and to enhance the ability of bank owners, management and regulators, and the markets themselves to provide for better governance and regulation to achieve the above-mentioned objectives. The reform program aims to (i) give greater autonomy to the Bangladesh Bank, (ii) strengthen the Bangladesh Bank's capabilities and technical skills to perform its enhanced responsibilities, (iii) strengthen prudential regulation and supervision, (iv) restructure the management and internal processes of SCBs and ultimately privatize selected SCBs and specialized banks, (v) strengthen the legal and judicial processes,

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[4] Bangladesh Bank. 2008. *Financial Sector Review.* Dhaka. p 12.

and (vi) improve the money and debt markets. Most recently, the reforms for developing the financial markets by the Bangladesh Bank and other authorities include development of the government securities market and the creation of an appropriate market support infrastructure.

ADB's interventions include the $80 million Capital Market Development Program[5] loan approved in 1997. The program loan aimed to enhance market capacity and develop a fair, transparent, and efficient domestic capital market. This would attract larger amounts of investment capital which can augment capital provided through the banking system and thereby improve efficiency in allocating resources. The Capital Market Development Program was designed to achieve (i) stronger market regulation and supervision, (ii) improved capital market infrastructure, (iii) modern capital market support facilities, (iv) increased supply of securities in the capital market, and (v) increased institutional demand for securities. The program's objectives were largely achieved. The program remains relevant to the country's strategy and development objectives, and has achieved significant progress in many areas, including strengthening regulation and supervision and developing infrastructure in the capital market. However, the reforms to increase the supply of securities and develop institutional demand have progressed slowly, due mainly to lack of government commitment and a shortage of competent staff. Overall, the Capital Market Development Program was assessed *partly successful* by ADB's Independent Evaluation Department.

The performance of the four SCBs is monitored under memorandums of understanding signed by each of them and the Bangladesh Bank, in relation to tightened prudential norms and lending limits. Their performance has been mixed, however, due in part to government-directed extensions of credit. The government has taken steps to corporatize the SCBs and make them more autonomous while keeping them under the regulatory purview of the Bangladesh Bank, with a view to eventual privatization. The sale of Rupali Bank—an SCB—has been cancelled and the bank has been given back to the government. The other three SCBs have been transformed into public limited companies, though they are fully owned by the government. The Bangladesh Bank has also completed a comprehensive plan to switch to the new international standard framework for assessing the capital adequacy of banks under Basel II,[6] which the government is implementing since early 2009. It established a settlement system for secondary bond trading in May 2005 and introduced mark-to-market[7] valuation guidelines for treasury securities effective from February 2006, which have improved operations of the interbank and treasury bill markets. It also introduced market-based auctions of treasury bills in September 2006 to bring greater flexibility to liquidity management.

To reinforce the government's financial sector reform program, the World Bank's Financial Institutions Development Project[8] was formally launched in February 2000. The project, which concluded in February 2006 and was administered by the Bangladesh Bank, made substantial progress towards sustainable financing of private sector initiatives to accelerate industrial growth in the country. The project's resource mobilization component simplified market regulations to facilitate bond and security issues and created and developed market-oriented mechanisms. Rules and procedures for bonds and debentures were developed and implemented. The marketing of government treasury bonds was also strengthened. Both the Bangladesh Bank and

5 ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Bangladesh for the Capital Market Development Program*. Manila.

6 The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank governors of the G10 countries in 1975. It is made up of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent secretariat is located. The Core Principles have been used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to be done to achieve a baseline level of sound supervisory practices.

7 The act of recording the price or value of a security, portfolio, or account to reflect its current market value rather than its book value.

8 World Bank. 1999. *Financial Institutions Development Project.* Washington, DC.

the SEC received training on debt instruments, and reforms were implemented in the government's National Saving Schemes.[9] Furthermore, procedures for a secondary treasury bond and bill market were also developed. Under the Financial Institutions Development Project's Strengthen Financial Institutions component, the Credit, Bridge and Standby Facility (CBSF) was created to encourage the development of term financing through a more efficient financial system. The CBSF provided funding from the International Development Association to financial institutions through a variety of mechanisms to increase their funding while enabling and encouraging them to mobilize medium- to long-term resources from the local market. The CBSF not only facilitated funding to NBFIs and financial institutions, but also strengthened these institutions by providing technical assistance on finance and management. In addition, the capacity of financial institutions was enhanced through business planning and resource management.

The World Bank is also strengthening the capacity of Bangladesh Bank[10] and is reforming the SCBs under the Enterprise Growth and Bank Modernization Project[11] and the Second Development Support Credit Project.[12] Progress on key reforms has been integrated in the International Monetary Fund's Poverty Reduction Growth Facility. The Government is facilitating the automation of the credit information bureau at Bangladesh Bank to ensure the availability of credit history for all SMEs through a 16-month grant project funded by the Department for International Development (DFID) of the United Kingdom and managed by the International Finance Corporation's (IFC's) SouthAsia Enterprise Development Facility (SEDF). The project commenced in May 2009 and will be completed by September 2010. This will enable coverage of all SME borrowers and will help the banks to shift from purely collateral-based lending to cash-flow-based lending that emphasizes greater reliance on character, better understanding of the business, and credit rating information at the outset of the credit relationship with SMEs.

[9] The government introduced the National Saving Schemes (NSS) to meet their expenditure requirements. The NSS are essentially local currency and foreign currency government bonds of various denominations and maturities. These bonds created market distortions by offering above-market premiums (in comparable terms) to eligible investors such as overseas Bangladeshi wage earners, retired government officials, and widows. For example, the rates for the Government Savings Certificate are 2%–3% higher after tax than the rates on other government paper (www.freeonlineresearchpapers.com/bond-market-bangladesh). The reform of the government's NSS was aimed at reducing these distortions that repressed potential demand for market-traded instruments caused by the government's NSS. This was accomplished by bringing benefits and returns of the NSS closer to market-oriented instruments.

[10] World Bank. 2003. *Central Bank Strengthening Project.* Washington, DC. This supports implementation of Bangladesh Bank's strengthening program by providing assistance in three major areas—legal framework, reorganization and modernization, and capacity building.

[11] World Bank. 2004. *Enterprise Growth and Bank Modernization Project.* Washington, DC.

[12] World Bank. 2003. *Second Development Support Credit.* Washington, DC.

Financial Sector Development and Issues in Bangladesh

Principles in Identifying Issues

Country-specific factors: the "four pillars" approach. The financial sector strategy is based on four interlinked pillars: (i) governance, (ii) support infrastructure, (iii) market, and (iv) human resource and capacity building. The governance pillar concerns the legal and regulatory framework, market transparency and disclosures, and market-based policies and practices among market institutions. The support infrastructure pillar covers issues such as the payments system, clearing and settlements, accounting and audit, and information dissemination. The market pillar concerns the supply of and demand for financial products and instruments and the role of financial intermediaries. Human resource development and capacity building are crosscutting themes.

The classification of four pillars will help narrow down the key strategic areas, while the integrated consideration of the pillars will help identify necessary collective actions in the context of Bangladesh. This in turn will help to maximize the impact of strategic actions undertaken in one pillar on the sector or subsector. Integrated consideration of all four pillars will also prevent any strategic action from being isolated from reality. For example, in the banking subsector the market pillar was developed in the initiating phase without sufficient parallel development of governance or the support infrastructure.

Given the lag in the development of the securities market and the lead role ADB has taken in this area, securities market issues will be more fully scrutinized than other subsector issues.

Structural Constraints

Limited role of the financial sector in resource mobilization and allocation. Bangladesh's domestic investment was 24.7% of GDP in FY2006 and 24.3% of GDP in FY2007. This was higher than that of Pakistan (21.8% for FY2006 and 23% for FY2007) but notably lower than that of India (35.9% for FY2006 and 38.4% for FY2007). The gross domestic savings rate in Bangladesh is low (20.5% in 2007) for the purposes of stimulating economic growth, especially compared to the neighboring countries of India (34.8% for 2006), Bhutan (37.4% for 2006), and the Maldives (32.9% for 2005). The low level of saving is associated with a high consumption pattern, a low level of financial intermediation, and low disposable income. Therefore a resource gap exists in Bangladesh, although it is slowly decreasing (Table 1).

Table 1: Resource Gap
(as % of GDP)

Fiscal Year	Gross Domestic Saving	Gross Capital Formation	Resource Gap
1990	17.7	22.2	(4.5)
2000	17.9	23.0	(5.1)
2001	18.0	23.1	(5.1)
2002	18.2	23.1	(5.0)
2003	18.6	23.4	(4.8)
2004	19.5	24.0	(4.5)
2005	20.0	24.5	(4.5)
2006	20.2	24.7	(4.4)
2007	20.5	24.3	(3.9)

( ) = negative number, GDP = gross domestic product.
Note: including rounding.
Source: *Asian Development Bank Key Indicators 2008*.

These statistics underline the need to accelerate domestic resource mobilization efforts and to improve the investment environment, particularly to attract foreign investors. The financial sector has to gain the confidence of investors, establish and develop a network of financial intermediaries, and produce a wide range of diversified saving and financing instruments that meet market needs. Currently, the government finances the country's resource gap by selling securities to financial intermediaries, issuing national saving certificates to the public, borrowing from the Bangladesh Bank, and obtaining foreign loans and grants. However, the Government of Bangladesh has been preempting funds from the public at above market rates. The auction system at the Bangladesh Bank is still price-determined rather than volume-determined, impeding the intermediation process. Therefore, the government should compete for funds on a market basis.

Weak financial structure. The domination of Bangladesh's financial structure by banks and SCBs poses a vulnerability to the overall financial system. Furthermore, there is a tight affiliation with unhealthy banks which poses a serious threat to the stability of the overall financial system. Devoid of an efficient capital market, banks were encouraged to take on additional risks other than credit risks, mostly in the form of politically driven loans. The government was reluctant to sever ties with easy loans, and this has drastically escalated public sector borrowing from the banking system. Bangladesh has the lowest ratio of market capitalization to GDP among the South Asian countries (see discussion under The Financial Sector in Bangladesh), and most households have no alternative but to deposit savings in the banks. As a result, efficient allocation of capital is an alien concept to most SCBs, which frequently lent on a noncommercial basis and compromised market discipline to the detriment of the proper formation of fair competition and transparency. Furthermore, the banks are also exposed to significant risk due to mismatches in assets and liabilities arising from the funding of long-term loans with short-term deposits. The prime hindrance to debt market development in Bangladesh is also attributed to the large number of banks with huge bad loan portfolios and the nontransferability of debt and savings instruments.

Low level of intermediation in the financial market. The financial sector has excess liquidity in the banking subsector.[13] A key reason for this excess liquidity is that the SCBs that dominate the financial sector cannot expand credit by more than 5% over the previous year according to an agreement with the International Monetary Fund (IMF) designed to limit the growth of these institutions' nonperforming loans. (However, in response to the global financial crisis, the Government in March 2009 doubled the lending limits of the SCBs to 10% to boost domestic investment.) The challenge is how to remove inefficiencies in the interbank market and transfer excess funds (lodged mainly with the SCBs and by the government) to NBFIs that have a large unmet demand for credit. This poses a serious constraint to credit in the financial market. With the interest rate on saving deposits at 5.2% and a time deposit rate of about 10.3% in 2006, and a lending rate of 15%–16% in 2006 and 2007, the interest spread could be viewed as wide and therefore indicative of the relative inefficiency of financial intermediation and resource allocation in the financial system.

Gaps in the legal and regulatory framework: lack of a framework for unsecured transactions and weak enforcement for debt recovery. The secured financing[14] sector is regarded as one of the most potentially dynamic segments of the Bangladesh economy. Financing institutions, including NBFIs such as lease financing companies, which extend

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[13] The excess liquidity (which is total liquidity minus statutory liquidity requirement amount, where total liquidity equals cash in tills plus balances with the Bangladesh Bank plus balances with Sonali Bank as agent of the Bangladesh Bank plus unencumbered approved) of the scheduled banks in Bangladesh stood at Tk95.9 billion or 27.3% of the total liquid assets of Tk351.5 billion as of the end of June 2006. This compares with the excess liquidity of Tk117.5 billion or 41.0% of the total liquid assets of Tk286.9 billion as of the end of June 2004. The Bangladesh Bank continuously pursued tighter monetary policy during FY2006 and became more successful in using its reverse repo tool for mopping up excess liquidity from the market.

[14] Secured financing refers to financing against movable property collateral such as equipment, vehicles, shares, and other property that is not land.

credit against movable property as collateral, are a small but growing part of the credit market.[15] Small and medium-sized enterprise (SME) debtors with relatively little land but more movable property assets are an important potential growth engine for the Bangladesh economy. Until the money loan courts were established, it was extremely difficult to proceed against a debtor in Bangladesh. The Money Loan Court Act's reform to allow creditors to sell collateral without a trial is a significant step forward. However, the major bottleneck lies in cumbersome enforcement procedures to sell collateral through public auctions.

Anticorruption, investor confidence, and establishment and implementation of law and order. The financial market suffers from low investor confidence. Debt and equity markets have yet to fully recover from the domestic capital market crisis of 1996 and the departure of foreign investors. Despite allegations of irregularities among stock market brokers, not a single case has been successfully prosecuted. Prevalent and widely accepted rent seeking behavior is the major barrier to improving the financial sector. Foreign aid and investment accomplish little if assistance does not flow directly to the targeted beneficiaries. Corruption is a financial mechanism and the financial sector is a key test area for establishing and implementing law and order. The financial sector must adopt market-based and transparent decision making to build confidence. Furthermore, institutions need to be set up to ensure that corruption is reduced. Recently, the government has taken an encouraging step in this regard by revitalizing the Anti-Corruption Commission. The government's effort was supported by the $150 million ADB Good Governance Program for Bangladesh,[16] approved in October 2007 (see section on Promotion of good financial market governance).

Lack of capacity building in terms of professionalism and expertise. Although there are over 320 licensed brokers and over 270 authorized representatives, there are no professional standards and only minimal qualification requirements (courses, examinations, or continuous professional training) are imposed on intermediaries by the SEC or the exchanges. Furthermore, the SEC has problems recruiting private sector professionals due to its low pay scales. Its dependence on the national budget and lack of financial independence limit its ability to attract qualified professionals. As a result, the SEC has limited capacity to regulate or monitor current activities within its remit and has insufficient resources to devote to functions such as training and instituting professional standards.

Banking Subsector

Recent Developments

Overview. The banking subsector dominates the financial sector in Bangladesh, while NBFIs and the capital market play a relatively limited role. Banking alone accounts for a substantial share of financial sector assets with 48 banks[17] accounting for about 90% of the sector's total assets as of the end of December 2007. The domination of the banking system by the SCBs is declining while PCBs and foreign commercial banks have been gaining market share in recent years, reflecting increased competition in the banking industry. Since 2002, the private sector banks (PCBs and foreign commercial banks) have consistently outperformed specialized banks and SCBs in terms of growth in deposits and bank advances. Recent data show that four SCBs together account for more than 30% of deposits and operate 3,383 branches (50% of the total) as of 30 June 2008. Nationwide, loan disbursements grew by 43% in the quarter ending September 2008. Therefore, even with deleveraging gaining further momentum in international markets due to the financial crisis, there has been little impact on Bangladesh's credit markets.

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[15] Although the Bangladesh credit market is still overdependent on bank credit (approximately 39% of GDP as of FY2006) as compared with nonbank credit (approximately 4% of GDP as of FY2006), there is substantial opportunity for growth of nonbank financial institutions as indicated by the increasing number registering under the Financial Institutions Act of 1993 and by the growth rate of leasing companies.

[16] ADB. 2007. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Bangladesh for the Good Governance Program.* Manila.

[17] There are 4 state-owned commercial banks (SCBs), 5 government-owned specialized banks, 30 private commercial banks, and 9 foreign commercial banks. SCBs account for about 50% of total deposits in the banking sector and specialized banks account for about 5%. The share of SCBs is declining.

Table 2: Ratio of Gross Nonperforming Loans[a] to Total Loans by Type of Bank

(%)

Bank type	2000	2001	2002	2003	2004	2005	2006	2007	2008
SCB	38.6	37.0	33.7	29.0	25.3	21.4	24.0	27.0	30.0
SB	62.6	61.8	56.2	47.4	42.9	34.9	34.0	33.8	27.9
PCB	22.0	17.0	16.4	12.4	8.5	5.6	5.8	5.9	5.4
FCB	3.4	3.3	2.6	2.7	1.5	1.3	1.2	1.1	1.5
Total	**34.9**	**31.5**	**28.1**	**22.1**	**17.6**	**13.6**	**13.2**	**13.2**	**13.2**

FCB = foreign commercial bank, NPL = nonperforming loan, PCB = private commercial bank, SB = specialized bank, SCB = state-owned commercial bank.

[a] Without adjustment for actual provision.

Source: Banking Regulation and Policy Department, Bangladesh Bank.

Nonperforming loans. The banking subsector has been heavily burdened by high levels of nonperforming loans (NPLs) which have accumulated over many years due to weak management of the SCBs. According to the Bangladesh Bank, the ratio of NPLs to total loans declined to 13.2% in March 2008 from 31.5% at the end of 2001 (Table 2). This reduction was achieved through provisioning and write-offs and by a sharp reduction in new bad debt. In addition, stronger regulation, enhanced legal powers of the banks to collect problem loans (e.g., through the money loan courts[18]), and better screening of new loans (facilitated by the Credit Information Bureau) have also improved the ratio. The government strategy, which is being implemented by the Bangladesh Bank with assistance from the IMF and the World Bank, includes limiting the annual credit portfolio growth of SCBs to 5%. (However, in response to the global financial crisis, the Government in March 2009 doubled the lending limits of the SCBs to 10% to boost domestic investment.) Banking subsector structural reform is well under way with the assistance of the Enterprise Growth and Bank Modernization Project[19] and the Poverty Reduction and Growth Facility.[20] These initiatives aim to bring about a competitive private banking system by reforming the SCBs through corporatization.

Issues in the Banking Subsector

In spite of the decline in the ratio of NPLs to total loans in Bangladesh (see section on Nonperforming loans and Table 2), the SCBs and specialized banks are still burdened with a large portion of NPLs. The NPL ratio for SCBs had increased to 30% at the end of March 2008 (compared with 29% at the end of 2003), while the ratio for specialized banks had declined to 27.9% at the end of March 2008 (compared with 62.6% at the end of 2000). Meanwhile, local private banks, particularly new generation private banks, have enjoyed a healthier financial position compared to SCBs, although some have also faced difficulties due to their large NPL portfolios. The NPL problem of the banking subsector can be traced to priority lending to loss-making state-owned enterprises (SOEs) in the past, a deficient legal and debt recovery framework, weaknesses in loan screening and supervision, lack of accountability of bank officials, and a weak credit culture. The NPL ratio of SCBs is very high compared with banks in other countries affected by the Asian financial crisis. The high NPL ratio harms profitability and capital adequacy ratios, and constrains the supply of credit for economic development. If the government is required to recapitalize the banks, there could be significant fiscal implications.

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18 The Money Loan Court Act 1990 introduced a court of exclusive jurisdiction for the recovery of nonperforming loans (NPLs) to expedite adjudication of creditors' claims. Significant improvements in the execution of the Money Loan Courts were made as part of the Money Loan Court Act 2003. The money loan court process, which is accepted by the banks, has been instrumental in improving the speed and efficiency of collateral acquisition and disposal, and in gaining judgments against uncooperative debtors.

19 Footnote 11.

20 The Poverty Reduction and Growth Facility (PRGF) for Bangladesh was approved in 2003. It is the IMF's low-interest lending facility for low-income countries. PRGF-supported programs are underpinned by comprehensive country-owned poverty reduction strategies.

Other issues of state-owned commercial banks. SCBs face many other problems including (i) inadequate loan monitoring and follow-up; (ii) poor governance; (iii) large and growing capital shortfalls; (iv) operational inefficiencies stemming from excessive staffing levels; (v) extensive and loss-making branch networks; (vi) low levels of computerization; and (vii) inadequate management of internal risks, including operational, credit, and foreign exchange risks. The state of the SCBs and their impact on the financial sector as a whole has caused the government to push for reforms in these institutions.

Debt recovery. The privatization and listing of SOEs, particularly SCBs, can play a crucial role in facilitating the development of the financial sector. Resolving the high level of NPLs and preventing new NPLs are prerequisites to the successful privatization of SCBs. The government has made some progress in improving the legal framework for debt recovery by enacting and amending from time to time the Financial Loan Court Act in 1990, the Bankruptcy Act in 1988, and the Money Loan Act in 2003. While the money loan court has filled many of the gaps left by the statutes and has enhanced the legal powers of banks to recover bad debts, the World Bank's recent study shows that enforcing contracts in Bangladesh is extremely difficult compared with other developing countries. The high level of NPLs at SCBs underlines the fact that the enforcement of contracts is a more urgent issue in Bangladesh than in any neighboring country.

Low efficiency. Despite the government's concerted effort to improve the financial sector through its focus on the banking subsector, the financial sector of Bangladesh remains at an early stage of development. The total annual cost of banking subsector inefficiency is estimated at about 1.2% of GDP. General and administrative costs in commercial banks amount to 3.1% of net assets, or 0.6% of current GDP, exceeding the international norm. The annual cost of servicing 10% coupon bonds issued to recapitalize banks in order to meet the statutory capital adequacy ratio, after adjustment for underprovisioning against loans and advances to SOEs and sector corporations, is 0.6% of GDP. The cost of servicing the recapitalization requirements of the development finance institutions (DFIs) and specialized banks is roughly 0.2% of GDP. Thus the aggregate cost of inefficiency of banks, DFIs, and specialized banks in Bangladesh is estimated at over 1.4% of GDP.

High intermediation costs. The high deposit and lending rates are a reflection of the system's embedded inefficiencies. Besides being highly fragmented, the banking subsector's inability to absorb external shocks and market volatility increases demand for a higher spread to cover additional risks undertaken by creditors. Therefore, high transaction and funding costs are incurred by corporate entities, business operators, NBFIs, and individuals. The interest spread between deposit and lending interest rates indicates an increasing trend over recent years in Bangladesh (Table 3). The widespread default culture has resulted in extensive and costly financial intermediation. In addition to loan defaults, other market distortions, including the high interest rates on government savings bonds[21] and government borrowings and poor pricing strategies of banks, have contributed to the wide interest spreads. The relatively more efficient private banks, including foreign banks, have reaped comparatively higher profits (Table 4). There are few cases of hidden subsidies, which do not overly affect the interest rate spread. For example, concessional lending is confined within the public sector development programs. In the case of any public support for onlending to the financial sector, market rates have been used.

Table 3: Interest Rate Spread (year end)

(%)

Year	All Banks	SCB	DFI	PCB	FCB
2004	5.27	4.88	3.71	5.52	7.39
2005	5.35	5.42	3.67	6.02	7.89
2006	5.61	5.63	3.18	5.44	8.12
2007	5.92	6.04	2.94	5.70	8.76
2008	5.75	5.85	2.88	5.36	9.02

DFI = development finance institution, FCB = foreign commercial bank, PCB = private commercial bank, SCB = state-owned commercial bank.

Source: The Bangladesh Bank.

[21] Government securities and savings instruments account for almost the entire limited amount of debt securities issued in the country. High interest rates offered on government savings instruments create a high baseline interest rate for corporate securities. As a result, development of the equities market is impeded and the market for issuing private debt securities is distorted.

Table 4: Profitability Ratio by Type of Bank

(%)

No of Banks	Return on Assets						Return on Equity					
	2002	2003	2004	2005	2006	2007	2002	2003	2004	2005	2006	2007
SCB	0.10	0.08	(0.14)	(0.10)	0.00	0.00	4.21	3.00	(5.75)	(6.90)	0.00	0.00
SB	0.33	(0.04)	(0.13)	(0.13)	(0.15)	(0.30)	5.76	(0.61)	(2.14)	(2.14)	(2.00)	(3.40)
PCB	0.75	0.69	1.24	1.06	1.07	1.30	13.56	11.37	19.53	18.10	15.19	16.6
FCB	2.36	2.55	3.15	3.09	2.17	3.10	21.47	20.39	22.47	18.40	21.53	20.4
Total	**0.52**	**0.49**	**0.69**	**0.60**	**0.75**	—	**11.56**	**9.75**	**12.97**	**12.40**	**14.13**	—

( ) = negative number, FCB = foreign commercial bank, PCB = private commercial bank, SB = specialized bank, SCB = state-owned commercial bank.
Source: Offsite Supervision Department, Bangladesh Bank.

Limited long-term infrastructure financing, including housing finance. The banking subsector relies primarily on short-term deposits as a source of finance. As a result, it is very difficult for the banking subsector to provide long-term financing for infrastructure projects. Furthermore, the need for housing finance remains largely unfulfilled. Housing loans outstanding as of June 2005 amount to about $1.5 billion. Banks, specialized housing finance organizations—such as the Housing Building Finance Corporation, Delta-Brac and National Housing, and other financial institutions—are active in the housing finance subsector. According to the IMF, housing finance is limited by the high cost and relative scarcity of long-term funds, which reflects the distortions in deposit and lending rates and lack of development of securities and long-term debt markets. The high cost of securities title to the property and weak enforceability of mortgage collateral further exacerbate the situation in housing finance. Maturity mismatch is one of the serious problems voiced by housing finance institutions, since lenders of housing finance require a stable source of long-term funds. The housing finance subsector lacks adequate financial instruments to mitigate liquidity and interest rate risks. A viable secondary market in mortgage securities backed by housing loans can increase liquidity of the primary lenders and broaden the asset bases of long-term funds providers such as pension and insurance companies.

"Missing middle". A burst of microcredit programs in the 1990s catered to the needs of the poor; however, self-employed individuals and very small enterprises that graduated from these programs were excessively underserved in terms of credit support. The growing number of disgruntled SMEs made both the government and multinational donor institutions take notice of the "missing middle" which constituted a huge gap in the credit subsector.[22] Large corporations can readily borrow from the formal credit subsector, and many microcredit programs are available to the poor. The state-owned Bangladesh Small Industries and Commerce Bank (BASIC Bank) provides loans to cottage industries and small enterprises but has been ineffective in seeking out potential SME clients that are geographically dispersed and where a vast information gap exists. The lack of credit support to SMEs is being addressed by the SouthAsia Enterprise Development Facility, which was established with ADB support in 2002 as a multidonor facility managed by the International Finance Corporation (IFC), and under ADB's SME sector development program loan (footnote 22). ADB also approved an SME

[22] ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Bangladesh for the Small and Medium Enterprise Sector Development Program.* Manila. This program loan mitigated the credit sector gap for the "missing middle" by providing a credit line of $30 million.

Development Project in September 2009. The project encompasses provision of medium- to long-term credit to nonurban and rural SMEs.

Securities Markets

Recent Developments

Overview. Bangladesh's capital market—the market for trading long-term debt and equity securities, consisting of primary and secondary markets—remains underdeveloped, despite recent improvements. The capital market is essentially equity-oriented, with two stock exchanges: the Dhaka Stock Exchange (DSE) and the Chittagong Stock Exchange (CSE).[23] The two stock exchanges maintain almost identical listing criteria and procedures, virtually all listed companies maintain dual listings, securities firms retain dual membership, and brokers possess dual licenses. The need for two almost identical exchanges is questionable; the suggested way forward is discussed in section on Stock exchanges, securities firms, and listed companies.

Government securities and savings instruments account for almost all of the nonbank debentures that are issued. As of 3 October 2008, a total of 400 equity and debt securities were listed on the DSE General Index. Since most companies and all mutual funds are listed on both stock exchanges, the exchanges offer limited investment alternatives and create opportunities for price arbitrage. Capital markets in Bangladesh showed progress during FY2008. According to the Bangladesh Bank, between June 2007 and June 2008 the monthly average of the Dhaka Stock Index increased by 55.1%, the DSE General Index increased by 49.6%, and the DSE 20 Index rose by 39.6%. The liquidity situation also improved during FY2008 compared with prior years. The daily average turnover stood at Tk2.3 billion in FY2008 compared with Tk0.7 billion in FY2007. This increase was largely due to share trading of banks, insurance companies, mutual funds, and power companies, including the recently listed Jamuna Oil Company and Meghna Petroleum.

The Dhaka Stock Exchange general index experienced ups and downs in FY2009, though its end-June level was essentially unchanged from a year earlier. As at end-July 2009, the index had registered a gain of 4.3% in 7 months. The expected listing of GrameenPhone, the country's largest mobile company, in October 2009 will deepen the market, encourage other large companies to list, and boost investor confidence. Lower corporate tax rates in FY2010 for mobile phone operators, provided that they list on the stock exchange, should encourage other mobile phone companies to follow.

The bond market is in its infancy. Fixed income securities first came into existence in 1987 with the flotation of debentures by two companies. Trading of government treasury bonds started in December 2005 on the DSE. At the end of March 2008, 8 debentures, 75 treasury bonds, and 1 corporate bond (floated in 2007 by the Islamic Bank Bangladesh named as IBBL Mudaraba Perpetual Bond) were being traded on the country's capital market. The total issued amount of the debt securities is about Tk212.9 billion, or about 21.4% of total market capitalization.

Progress in the capital market has been helped by the establishment of a central depository system and an automated trading system under ADB's Capital Market Development Program (see discussion under ADB's Development Experience) a substantial increase in the minimum capital requirement of banks and nonbank financial institutions,[24] which led to them raising capital by issuing new shares, and the introduction of credit ratings before an initial public offering (IPO).[25] Lower interest rates on long-term government savings instruments, an increase in overseas workers' remittances, and tax incentives for equity investment have also contributed to the growth in capital market activity. Nonetheless, long-term prospects for capital market development remain mixed.

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[23] The East Pakistan Stock Exchange Association was incorporated in 1954 as a public company. In 1962, the name was revised to the East Pakistan Stock Exchange and again to the Dhaka Stock Exchange (DSE) in 1964. The Chittagong Stock Exchange (CSE) was established in 1995.

[24] The Bangladesh Bank increased the minimum capital requirement from Tk0.4 billion to Tk1.0 billion for banks and from Tk0.1 billion to Tk0.25 billion for nonbank financial institutions.

[25] As of June 2004, all banks are required to mention their credit rating evaluation report in their prospectus when they go to the public to raise funds through initial public offerings (IPOs).

Investment Corporation of Bangladesh. The Investment Corporation of Bangladesh (ICB)[26] was established in 1976 as a fully government-owned institution operating under a special charter with the objective of encouraging and broadening the industrial investment base. It subsequently became a corporation owned partially by the government under the supervision of the Ministry of Finance. In 2002, the ICB was transformed into a holding company by establishing three subsidiaries and delegating its new business to these subsidiary companies.[27] The ICB underwrites issues of securities, provides substantial bridge financing programs, maintains investment accounts, and floats and manages closed-end and open-end mutual funds and closed-end unit funds to ensure supply and generate demand for securities. The organization also operates in the DSE and the CSE as a dealer. More than 30 years later, the ICB remains the single largest integrated capital market operator with over 75,000 investors' accounts, and manages eight listed closed-end and one open-end mutual fund. In FY2006 the ICB and its subsidiaries had a turnover of Tk4.25 billion at the DSE (9.2% of the total turnover volume at the DSE) and Tk2.56 billion at the CSE (22.4% of the total turnover volume at the CSE). To address conflicts of interest in its combined operations and to make the capital market fairer, three separate subsidiaries were created at the ICB in 2002. Since the ICB has refused to open its books for external audit, its financial position is unclear.

Capital Market Development Issues

Overall Issues

The capital market has a low level of supervision and the major market players—such as stock exchanges, brokers, dealers, and asset managers—have limited professional capacity. Transparency is poor and there is inadequate disclosure both in trading and in the quality of information provided for listed companies. The introduction of up-to-date technology to support market infrastructure has been slow. Widespread reports of malpractice culminated in a domestic stock market crisis in 1996. As a result, investor confidence is low.

The stock exchanges are owned and dominated by brokers, so their businesses take precedence over the governance of their respective exchanges. The management of the two exchanges is weak at the strategic, senior, and mid-management levels; hence their members' activities are not supervised or regulated effectively.

Gaps in legal and supervisory framework, and weak implementation capacity. Governance structures are deficient and market regulators have ineffective enforcement and weak implementation capacity. Regulations were introduced under the Capital Market Development Program, and the Securities and Exchange Commission (SEC) was established and given the mandate to oversee the operation of the capital market; however, recurring violations of securities laws and regulations have been reported. The absence of convictions in cases filed in connection with the 1996 stock market scam is a reflection of the lack of credibility and effectiveness of the SEC as regulator.

Under the Capital Market Development Program, the capacity to regulate and supervise capital market activities has been strengthened with the amendment of the SEC ordinance giving it rule-making power. However, public concerns have been expressed

[26] The Investment Corporation of Bangladesh (ICB) was established on 1 October 1976 under the Investment Corporation of Bangladesh Ordinance 1976 to accelerate the pace of industrialization and develop a sound securities market in Bangladesh. The ICB provides various types of investment, banking, and nonbanking services. As of December 2007, the key shareholders of the ICB are the Government of Bangladesh (27% of total shares), state-owned commercial banks (SCBs) (23%), state-owned development financial institutions (26%), and insurance corporations (12%). The ICB underwrites issues of securities, provides bridge financing programs, maintains investment accounts, and manages mutual funds' unit funds to ensure supply of securities as well as generate demand for securities; it also operates in the DSE and CSE as dealers. With the enactment of the Investment Corporation of Bangladesh (Amendment) Act in 2000, the number of activities undertaken by the ICB has increased through the formation of subsidiaries.

[27] This was supported by ADB's Capital Market Development Program Loan (approved in 1997) to restructure the ICB by creating three new subsidiaries to undertake merchant banking, mutual fund operations, and stock brokerage activities. The three ICB subsidiaries became operational in July 2002. The three subsidiaries are (i) ICB Capital Management (a merchant bank), (ii) ICB Asset Management (a manager of trusts and funds, including mutual funds), and (iii) ICB Securities Trading (a stock broker and securities dealer). Examples of current business activities being conducted by ICB include direct purchase of shares and debentures; participation in and financing of joint-venture companies; provision of lease finance; management of existing investment accounts, mutual funds and a unit fund, and portfolios of existing businesses that existed before the establishment of the three subsidiaries; acting as trustee and custodian; providing investment counseling to investors; and providing consumer credit.

about the pervasive powers of the SEC and lack of accountability within its organization. Complaints have been aired about shortcomings in the SEC's consultation process when issuing a new rule or regulation. The SEC is understaffed and its staff lack technical knowledge and skills. Although its oversight and regulatory functions have more than doubled, staffing of the SEC has remained severely inadequate and its remuneration structure is not attractive to potential qualified applicants from the private sector. The SEC's low pay scales are in turn a result of its dependence on the national budget and its alignment with civil service salaries, and its consequent lack of financial independence further limits its ability to attract qualified professionals.

Recruitment and career progression are constrained by government policy. As a result, the SEC has limited capacity to regulate and monitor activities within its remit and has limited resources to devote to development functions. There are too few qualified accountants and financial analysts due to high staff turnover, and the SEC does not have enough legal experts to effectively exercise its oversight authority. About 20 cases have been filed by the SEC against companies and brokers for violation of SEC rules. Even though there is a separate bench at the High Court to deal with company-related matters, all cases remain unresolved.

Inadequate systems and surveillance. The trading and surveillance systems and standards are inadequate. Good governance depends on having sound technical infrastructure in place, but neither the SEC nor the exchanges have effective automated systems of surveillance to help them detect market abuse. The Securities and Exchange Commission Automation System was installed in 2001 with ADB funding through the technical assistance project for Capacity Building of the Securities and Exchange Commission and Selected Capital Market Institutions. It is a management information system comprising 10 modules that was developed to automate data recording and retrieval, and it functions as a data accumulation and reporting system that performs only a limited amount of analysis. One of the system's modules—the surveillance module—was not designed to provide online market surveillance. Consequently, the system is no longer adequate for the market surveillance function it now needs to perform. This is evidenced by the amount of time taken to produce reports from the surveillance module. A modern market surveillance system, including an online market surveillance system, is required to allow the SEC to effectively fulfill its regulatory and supervisory mandate.

At the CSE, the responsibility for surveillance, market operations, and listings has been combined into one area called "market operations". The DSE is also in the process of combining operations into one area. However, at both exchanges, great care must be taken not to mix the distinct roles of surveillance and business development. Attracting and approving companies for listing is a business development role, while ensuring their compliance with the continuing disclosure obligations of listing is a surveillance role.

Surveillance at the exchanges concerns the issuers' obligation of disclosure and monitoring of the trading portfolio of brokers, market manipulation, and insider dealing. The present systems are relatively basic in design, and if they were all operated online would stretch the computing capacity of the trading platforms. For this reason, some of the activities are carried out offline. The cost of upgrading to a modern and efficient market surveillance system for the exchanges and the SEC, including training in its use, is estimated at $300,000 each.[28]

Neither exchange has an effective system designed specifically to monitor market abuse or suspected market abuse,[29] nor do they have adequate automated information control systems to maintain and monitor progress on suspected cases or the failure of companies to comply with their disclosure obligations. Cases are handwritten or typed and are not retained in a central surveillance monitoring system.

[28] ADB. 2005. *Technical Assistance to Bangladesh for Preparing the Financial Markets Governance Program*. Manila. Source for cost estimate is based on consultant's report on Demutualization and Merger of the Dhaka and Chittagong Stock Exchanges. This figure is based on estimates for a similar system for another securities regulator in South Asia.

[29] Market manipulation and insider dealing.

The staff at the exchanges lack training in market surveillance, evidence gathering, and analysis of data. A common complaint from brokers is that surveillance staff, in their eagerness to identify cases of market manipulation, often mistake basic trading strategies for something more sinister.

The SEC does not have an independent system for monitoring the CSE and the DSE. SEC staff use a surveillance terminal from the CSE, together with a remote terminal (not a surveillance terminal) from the DSE. Staff of the SEC, CSE, and DSE monitor the same surveillance and trading screens to identify abnormalities in trading.

Shortage of quality securities. In June 2009, the total market capitalization of the equity capital market in Bangladesh was 21% of GDP. Bangladesh has the lowest ratio of market capitalization to GDP among the South Asian countries (see discussion under The Financial Sector in Bangladesh). The limited number of listed securities has constrained increases in the liquidity and market capitalization of the stock exchanges. In addition, would-be investors have restricted investment choices because of the lack of high-quality equity issues, investment-grade equities, and debt instruments in the market. There were 303 securities listed on the DSE as of 30 June 2006, consisting of 256 companies, 13 mutual funds, 8 corporate debentures, and 26 Treasury bonds. On the CSE, there were 213 securities listed, consisting of 198 companies, 13 mutual funds, and 2 corporate debentures. The total number of listed companies has increased by 41 from FY2005 to FY2008. There were 17 IPOs in 2006, which is the same number as in 2005. However, most of them were made by insurance companies and nonbank financial institutions (NBFIs) under regulatory obligation. The main impediments to increasing the number of new listings are the inefficient pricing mechanism, the owner's concerns over poor corporate governance, and the high cost of listing.

The stock market appears to have recovered gradually from the very low investor confidence of 1996 to generate demand in the capital markets. The DSE general index stood at 2,854 on 10 September 2008, compared to 968 at the end of 2003. In the past few years, there has been an overwhelming response for IPO shares, and these have been heavily oversubscribed. In 2005, public subscription was 11.5 times higher than the public offering, in comparison to 12.1 times higher in 2004 and 18.5 times higher in 2003. This indicates a mismatch between demand and supply in the capital markets. For example, on the equity supply side only 17 securities were listed in 2005. In contrast, substantial demand exists, reflecting remittances, idle liquidity of the rich, and restriction in SCBs, although the long clearing period of 4 days still dampens demand. This mismatch between supply and demand is also indicative of speculation and distrust in the market. Many government-owned enterprises, including the petroleum distribution companies and Biman Bangladesh Airlines, as well as major private companies such as mobile phone companies with huge annual turnovers, could be prime candidates for the sale of shares to invigorate the equity market. Two power sector entities—the Dhaka Electric Supply Company and Power Grid Company of Bangladesh—have set the right example by successfully selling shares and thereby stimulating the capital market.

Lack of professional standards for licensing. The categories of market participants requiring a license from the SEC include (i) brokers, who provide trading services to clients; (ii) dealers, who are permitted to trade for their own account; (iii) merchant bankers, who provide underwriting, issue management, and portfolio investment services; (iv) investment advisors, who provide investment advice to clients;[30] and (v) authorized representatives, who are engaged in a broker's office to trade on the exchange on behalf of a broker or dealer. Although there are over 320 licensed brokers and over 270 authorized representatives, there are no standards or minimum qualification requirements (courses, examinations, or continuous professional training) imposed by the SEC or the exchanges on any of the intermediaries.

Debt Market Issues

An economy with an underdeveloped long-term bond market is constrained from meeting its long-term financing needs, which are principally infrastructure development. Moreover, savings cannot

[30] The ICB has been given permission by the government through regulations, and merchant banks are also functioning as investment advisors.

Table 5: Yields on Various Instruments

Fiscal Year	National Saving Certificate	PCBs: From 1 Year & above	Saving Deposit WA	Lending Rates WA	TB Rates of 364 Days
FY 2005	10.0–15.8	7.5–9.5	5.6	10.9	7.0
FY 2006	11.5–12.5	11.0–13.0	6.7	12.1	8.3
FY 2007	11.5–12.5	10.5–12.5	7.0	12.6	8.4

FY = fiscal year, PCB = private commercial bank, TB = treasury bill, WA = weighted average.
Note: Weighted average interest rates include all banks of all maturities.

be fully mobilized and structural deficiencies in the banking subsector cannot be complemented by the contractual savings institutions. Without a liquid, active secondary market in securities, matching the maturity requirements of both investors and issuers becomes more difficult, in particular with respect to long-term maturities in the primary market. In addition, the inability to securitize assets, particularly nonperforming loans (NPLs), hinders the efforts of banks in financial distress to restructure their assets and improve their capital adequacy and liquidity ratios. Another foregone benefit is the valuable monitoring function of corporate debt over reckless managers, which can improve the efficiency of resource allocation. Nepal and Bangladesh have some of South Asia's least developed debt markets, and Bangladesh has the region's smallest outstanding market size relative to GDP.[31]

Lagging development of government bond market. Government bond market development typically precedes the development of a corporate bond market. Demand-side weakness suffers from (i) a shortage of opportunity for trade and transfer; (ii) lack of any discount houses, money market dealer network, and secondary market for government securities; and (iii) limited opportunities for bond utilization.[32] However, progress is being made and opportunities now exist for trading and transfer of government securities. An active primary dealer system is in place and secondary trading of government securities is picking up gradually. There is an improvement in the demand for fixed-income securities, which was hitherto limited due to the captive nature of the primary markets under a controlled, below-market interest rate environment. The yield of government securities is becoming more and more market oriented. In FY2006, for total deficit financing the government relied on (i) the banking system for 42% of financing, (ii) foreign financing for 37%, and (iii) nonbank borrowing (treasury bills and bonds) for the remaining 21%.[33] Volume-based auction of government securities has been introduced since FY2007. Bangladesh Government Treasury Bonds of 5, 10, 15, and 20 years' maturity are experiencing greater acceptance. The Bangladesh Bank regularly furnishes a primary auction-based yield curve on its website and a secondary benchmark yield curve for government securities is under development. The current pricing of government securities based on primary yield curve will contribute to the development of a secondary market benchmark yield curve.

Lack of demand for debt securities. The extraordinarily high-yield structure on savings schemes is the major impediment to the development of a debt market (Table 5). This artificially high-yield premium on savings schemes tends to drive up the cost of bank deposits and deters the issuance of market-priced private sector debt instruments. The government reduced the rates on several occasions to relieve pressure on commercial bank lending rates and capital market yields; however, these efforts were viewed as artificial and tended to offer a one-off remedy. Since the current yield of

31 World Bank. 2008. *South Asian Bond Markets*. Washington, DC.

32 Government securities can be counted as statutory liquidity requirement.

33 Total deficit financing of the government was Tk130.57 billion in FY2002, of which foreign financing was Tk58.58 billion, financing from the banking system Tk24.87 billion, and net nonbank borrowing from the public Tk47.11 billion (excludes saving certificates held by the banks and includes treasury bills and treasury bonds held by the finance institutions). Similarly, total deficit financing was Tk134.73 billion in FY2006, of which foreign financing was Tk50.47 billion, financing from the banking system Tk56.68 billion, and net nonbank borrowing

government securities is not significantly different from the yields of saving schemes, individuals also begin to invest more in government securities, especially in treasury bonds. The lack of a long-term debt market makes it even more difficult to set a benchmark to determine long-term borrowing and lending interest rates. Financial institutions and corporate entities relying on banks for funds constantly experience difficulties stemming from maturity mismatches in their asset–liability positions.

Rudimentary secondary markets. Savings schemes and redeemable instruments with high yields accounted for 59.3% of the government-related instruments; the balance is made up of treasury bills (26.7%) and treasury bonds (13.9%). Private sector instruments are debenture-type issues mainly from one business group listed in the stock exchanges. With the exception of treasury bills and private sector debentures, fixed income securities are nontransferable. Five- and ten-year government treasury bonds were first traded in the secondary market on 1 January 2005. Government securities dealers and market makers have to be further developed. Developing a well-functioning secondary market for debt and asset-backed securities is expected to correct the persistent liquidity imbalance in the market. The Bangladesh Bank has recently introduced repurchase agreements as a prelude to the creation of a secondary money market for government securities, and the recent electronic securities registry by the two stock exchanges is expected to significantly promote and facilitate secondary market trading.[34] The Bangladesh Bank has set up the Public Debt Management Office[35] to deal with the development of debt instruments and the policy formulation of the repurchase agreement markets.

Impediments to the corporate debt supply. The development of the domestic bond market requires improvements in the support infrastructure and the type of instruments issued and traded, including the development of credit rating agencies, and the introduction of asset-backed securities and infrastructure bonds and instruments for hedging interest rate risk. According to the latest World Bank report on the South Asia bond market (footnote 31), there has been no infrastructure bond financing in Bangladesh so far, although one transaction is in the pipeline. The Industrial and Infrastructure Development Finance Company, a Bangladesh development finance institution, plans to launch the country's first ever infrastructure bond to arrange finance for four small power plants for $56.47 million.[36] The absence of a sovereign credit rating is an obstacle to securing long-term access to foreign credit and may be one of the underlying factors that discourage private international investors from investing in Bangladesh. Credit rating agencies play a valuable role in ensuring that companies disclose transparent accounts of their financial operations, while promoting greater financial discipline. The rating process itself provides incentives for self-discipline and self-regulation, so

[34] Through ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grants to Bangladesh for the Capital Market Development Program*. Manila; ADB. 2001. *Small Scale Technical Assistance to Bangladesh for Central Depository Capacity Building.* Manila; ADB. 2000. *Technical Assistance to Bangladesh for Capacity Building of the Securities and Exchange Commission and Selected Capital Market Institutions.* Manila; and ADB. 2002. *Central Depository Bangladesh Limited.* Manila. ADB supported the establishment of the central depository system for the Electronic Registry of treasury bills.

[35] In the Bangladesh Bank, the Public Debt Management Office under the Forex Reserve and Treasury Management Department of Bangladesh Bank handles (i) management, maintenance, and investment of foreign exchange reserves held by the bank; (ii) maintenance of clearing accounts of authorized dealers in foreign exchange; (iii) the making of transactions in foreign currencies with authorized dealers on a cash or spot basis; (iv) settlement of transactions among Asian Clearing Union member countries through the Asia Clearing Union mechanism; (v) repayment of government external debt, including debt servicing and making arrangement for miscellaneous remittances; (vi) keeping of the accounts for the funds and/or loans received from donors and disbursement thereof, and collection of foreign currency checks on behalf of government; (vii) issuance of public debt instruments and/or government securities, e.g., treasury bills, bonds, prize bonds, savings certificates, and formulation and implementation of rules, policies relating thereto consistent with government decisions and orders, and estimation of budget for the same; and (viii) framing policies regarding repo and reverse repo.

[36] The same World Bank report also proposed a potential source for financing the infrastructure projects through bond issues from the remittances of nonresident Bangladeshis working abroad. "In fiscal 2006 such remittances amounted to about $4.6 billion. In 2007 the remittances grew by a record 23%. A recent study found that almost 80% of remittances to Bangladesh go to nonproductive expenditures (International Network of Alternative Financial Institutions, 2006). Through savings instruments that the government offers for nonresident Bangladeshis (such as nonresident foreign currency deposits, US Dollar Premium Bonds, and Wage Earners Development Bonds), some of these funds could be pooled and used instead to finance infrastructure bonds."

that companies seeking favorable financing terms are forced to ensure that their financial management is sound and documented according to standard credit rating methods. However, under current circumstances, increasing the number of credit rating agencies is not essential in the case of Bangladesh with few opportunities for local issue or placement of fixed income securities. Instead, credit of listed and to-be-listed companies could be enhanced by a bank guarantee, which could also save security issuance costs. As more issuers have sufficient incentive to securitize, and as further investors subscribe, demand-driven establishment of credit rating agencies is expected. Bangladesh's two credit rating agencies are still at an early stage of development. Other main reasons for the low supply of viable corporate debt instruments include the poor credit standing of issuing corporations, statutory restrictions on the issuance of fixed-income instruments, the high cost of debt issuance, and the availability of lower-cost bank financing.

Equity Market Issues

Stock exchanges, securities firms, and listed companies. The two stock exchanges—the DSE and CSE—maintain almost identical listing criteria and procedures, virtually all listed companies maintain dual listings, securities firms retain dual membership, and brokers possess dual licenses. As a result, there have been calls for the demutualization of the stock exchanges and also merging of the exchanges to remove inherent conflicts of interest, eliminate opportunities for arbitrage between the exchanges, and enhance liquidity and public trust.[37] The listed companies are also partly responsible for the poor performance of the two stock exchanges. They run the risk of alienating investors by continuing their opaque management practices. Strong corporate governance and transparency are not yet ingrained within the corporate system. Applicable regulations and supervision for securities firms, investment funds, and the stock exchanges are deficient. Recently, the SEC has promulgated a rule on merger and acquisition of substantial numbers of shares in ailing companies, claiming to help investors get returns from such listed sick companies by taking over their management. A market maker rule was introduced in late 2000 but has yet to attract applications from prospective licensees. Furthermore, no new asset management company or mutual fund was floated in FY2007 and FY2008, due mainly to complicated regulatory requirements, the high cost and fee schedule, the management and operational hindrances placed by the regulatory regime, as well as the time-consuming and complicated nature of the legal process.

Following the stock market scandals in 1996, a deep public distrust of securities firms seems to have developed. In response, the SEC has undertaken a number of measures against the brokers, bourses, and listed companies for violation of rules, including removal of the chief executive officer of the DSE—a move which is being challenged in court. The SEC suspended the trading of securities of the Beximco Group—the country's largest conglomerate—and the group has challenged the authority of the SEC at the High Court by formulating rules which bypass acts of parliament. The Bangladesh Association of Publicly Listed Companies and the business chamber bodies are also at odds with the SEC on various corporate issues. There are new restrictions on the transfer of shares outside the stock exchanges, including inheritance and gift, which require prior permission from the SEC for such transfers and application through a member of the stock exchange. Furthermore, the SEC has instructed that listed companies which declare 60% less dividend than declared in the past year shall not enjoy day-netting facilities in public trading at the stock exchanges. These issues raise further questions which require speedy resolution.

Investment Corporation of Bangladesh. The objectives of the unbundling of the ICB's operations have yet to be achieved. ICB mutual funds created before 2002 are not regulated under the SEC's mutual fund rules, and there is no separate and independent trustee or custodian for the funds. The funds managed by the ICB borrow regularly to finance equity investments, which is not in line with international best practice and is highly risky. The practice of borrowing for stock investment is also a great market distorter, since the borrowing is from the parent company at a discounted rate (averaging 9%–10% per annum) against the normal average commercial bank overdraft

[37] ADB. 2005. *Technical Assistance to Bangladesh for Preparing the Financial Markets Governance Program*. Manila. The benefits of the merger and demutualization of the stock exchanges are elucidated in the final report.

rate of 16%–18% per annum. The ICB does not publish the net asset value of the mutual funds nor does it submit performance reports to the SEC, as private mutual funds must do by law, thus creating an uneven playing field. The organization operates under its own special charter, the ICB Act, and its valuation method is not available to the public. Historically, the ICB has declared dividends even when markets are inactive.

Other market participants. The third group of participants in the equity capital market are the specialized banks such as the Bangladesh Shilpa Bank, Bangladesh Shilpa Rin Sangstha, the BASIC Bank, a few foreign banks, and SCBs. The mutual fund promoted and managed by Bangladesh Shilpa Rin Sangstha, which is a state-owned development finance institution (DFI), also enjoys similar privileges and immunities to the ICB. Bangladesh has a small community of 29 merchant banks licensed by the SEC. These merchant banks lack skilled personnel and possess too small a market share to exert any impact in the domestic capital market. The pool of organized investment funds is miniscule since the merchant banks have failed to build up a viable retail client base. Complementing the role of merchant banks are 323 securities firms that are members of the stock exchanges. These companies suffer from low capitalization, weak governance, and inefficient operations.

Nonbank Financial Subsector

Recent developments. Nonbank financial institutions (NBFIs) are licensed and controlled by the Financial Institutions Act of 1993. These institutions (i) give loans and advances for industry, commerce, agriculture, or housing; (ii) carry on the business of underwriting or acquisition of, or the investment or reinvestment in, shares, stocks, bonds, debentures, or securities issued by the government or any local authority; (iii) engage in hire-purchase transactions, including leasing of machinery or equipment; (iv) finance venture capital; (v) provide loans for house building and property purchases; and (vi) use their capital to invest in companies. The major differences between NBFIs and commercial banks are that NBFIs cannot accept any deposit which is payable on demand by checks, drafts, or orders drawn by the depositor, and they cannot deal in foreign exchange. Since July 2005, NBFIs have been allowed to receive deposits of a minimum of 6 months' tenure only in the case of institutional deposits; prior to this instruction, NBFIs were not allowed to receive deposits of less than 1 year's tenure. NBFIs are expected primarily to fill in the gaps in the supply of financial services that are not generally provided by the banking subsector and to complement the banking subsector in meeting the financing requirements of the evolving economy.

There were 29 NBFIs operating in Bangladesh as of 2008. Of these institutions, 1 is government owned, 15 are local (private), and the other 13 are established under joint-venture arrangements with foreign institutions. The minimum capital requirement of NBFIs is Tk250 million. All NBFIs are required to raise their minimum capital through initial public offering (IPO) by June 2006. As of June 2005, the total paid up capital of NBFIs was Tk6.93 billion and their reserves were Tk5.52 billion, amounting to a total shareholder equity of Tk12.45 billion. The Bangladesh Bank introduced a policy for loan and lease classification and provisioning for NBFIs from December 2000 on a half-yearly basis. To enable the financial institutions to mobilize medium- and long-term resources, the World Bank's Financial Institutions Development Project established the Credit, Bridge and Standby Facility (CBSF) to implement the financing. The major business of most NBFIs is leasing, although some are also engaged in merchant banking and housing finance (Table 6).

Leasing subsector. In a market with considerable competitive pressures from banks and other financial institutions, the leasing industry has shown significant resilience. Its total assets grew at an annual average rate of 34% during 2002–2006. Lease financing constitutes 54.5% of the total long-term assets in the country's financial sector, with the rest consisting mainly of term financing. Leasing companies offer their services to industries such as textiles, chemicals, services, pharmaceuticals, transport, food and beverage, leather products, and construction and engineering. Some leasing companies are also diversifying into other lines of business, such as merchant banking, equity financing, term lending, and house financing.

Table 6: Investment Portfolio Mix of Nonbank Financial Institutions, 2002–2006
(10 million taka)

Investment Portfolio	2002 End-Dec	%	2003 End-Dec	%	2004 End-Dec	%	2005 End-Dec	%	2006 End-June	%
Lease	1,646.89	56.7	2,127.24	58.4	2,537.46	47.7	3,115.73	45.9	3,356.59	45.9
Term Loans	561.71	19.4	820.33	22.5	1,713.52	32.3	2,310.02	34.0	2,457.80	33.6
Housing Loans	414.33	14.3	513.74	14.1	666.85	12.5	894.15	13.2	1,026.23	14.0
Other Assets	170.70	5.9	182.81	5.0	240.42	4.5	106.46	1.6	120.76	1.7
Investment (Shares and Equities)	108.42	3.7	0.00	0.0	160.06	3.0	362.50	5.3	353.12	4.8
Total Outstanding:	**2,902.05**	**100.0**	**3,644.12**	**100.0**	**5,318.31**	**100.0**	**6,788.86**	**100.0**	**7,314.50**	**100.0**

Insurance and Pension Subsectors

Recent Developments

Insurance subsector. The country's insurance subsector is an important provider of long-term capital and is growing very rapidly. As economic growth accelerates, the need for insurance protection and new insurance products increases.[38] However, the country's insurance premium per capita was only 2.5% in 2004, compared with 4.0% in Pakistan and 19.7% in India. Penetration (in terms of premiums as a percentage of GDP) remained very low in 2004: only 0.6% for Bangladesh, compared with 2.9% for India and 0.6% for Pakistan. General insurance is provided by 44 companies and life insurance is provided by 18 companies. The industry is dominated by the two large state-owned companies—the Sadharan Bima Corporation for general insurance and the Jiban Bima Corporation for life insurance—which together command most of the total assets of the insurance subsector and about 15% of premium income in their respective subsectors. The Sadharan Bima Corporation benefits substantially from reinsurance premium income, since it is compulsory for general insurance companies to reinsure up to 50% of their total reinsured assets with the Sadharan Bima Corporation.

Private insurance companies are currently regulated by the Office of the Chief Controller of Insurance (OCCI), Ministry of Commerce, under the Insurance Act 1938. The two state-owned insurance corporations (the Jiban Bima Corporation and the Sadharan Bima Corporation) are regulated by the government under the Insurance Corporation Act 1973. To respond to concerns in the insurance subsector, the government formed the high-powered Insurance Reform Committee to review the existing situation and recommend possible courses of action, including updating the rules and regulations governing insurance companies. The committee recommended (i) dissolving the OCCI and establishing an insurance development board to oversee and regulate the insurance subsector; (ii) amending the Insurance Act 1938, Insurance Regulations 1958, and Corporation Act 1973 to reform the subsector; (iii) increasing the paid-up capital of the Sadharan Bima Corporation from Tk200 million to Tk1 billion, offloading 49% of its shares to the public, and carrying out only reinsurance business; (iv) handing over all government insurance business to the private sector; and (v) creating a reinsurance pool and a committee to be equally shared by the Sadharan Bima Corporation and the Bangladesh Insurance Association to look after reinsurance interests.[39] Following good governance

[38] Premiums grew by 22% a year for life insurance and 11% a year for general insurance during 2001–2003.

[39] The Committee for Updating the Insurance Act and Rules, consisting of representatives from the government and the private sector, contributed to the report of the Financial Sector Reform and Strengthening Initiative (FIRST), Insurance Law Reform Project (2003). The report made recommendations for the insurance industry and provided inputs for the draft insurance act. ADB prepared earlier draft amendments for the Insurance Act and Rules through ADB. 1993. *Study in the Insurance Industry and Pension and Provident Fund Operations in Bangladesh*. Manila.

best practices, the Insurance Development Board would be autonomous,[40] and would regulate not only private insurance companies but also the two state-owned insurance corporations under a uniform regulatory framework. Restructuring the state-owned insurance entities following international best practices and liberalizing compulsory reinsurance arrangements are part of the reform agenda for the insurance subsector.

Pension fund subsector. The government provides a compulsory pension scheme for its staff. The deposit into the pension fund is deducted and deposited in the government account at the rate of 12.5% of the monthly basic salary. Staff can deduct more money under the scheme and obtain the benefits when they retire. There is no such provision in the private sector service rules of companies or corporate bodies, however. The commercial banks have a depository pension scheme through which longer-term saving is undertaken for all, irrespective of whether they are private or public servants or individuals. The development of this pension scheme for the private sector and corporate bodies may help foster resource mobilization in Bangladesh.

Insurance and Pension Subsector Issues

The insurance subsector is marked by rapid growth of resources, significant proliferation in the number of participants beyond what the market can possibly support, and the continued dominance of life insurance by the state-owned Jiban Bima Corporation and of general insurance by SCBs. Both the Jiban Bima Corporation and the SCBs are generally viewed as operating on a substandard basis, with weak financial structures, a narrow range of insurance products, and poor services nurtured by the absence of minimum standards of service. In general, insurance salespeople are poorly trained and lack motivation, while their companies lack accurate demographic statistics to serve as basis for actuarial computations. Furthermore, insurance companies do not provide reports to policyholders, and the limited range of investment outlets for insurance funds prevents these firms from being active participants in the financial markets. These deficiencies indicate a rudimentary insurance market. Divestment of the state-owned insurance entities and the placing of the OCCI under the Ministry of Finance, instead of the Ministry of Commerce, are part of the organizational streamlining that has been proposed.

There is low awareness of the products and services offered by the insurance industry. The government has viewed it as a sector of industry rather than as part of the financial sector and therefore it has been difficult to include the insurance industry in financial sector regulations. The absence of a strong legal framework for addressing customer grievances has contributed to the industry practice of failing to settle claims, or of defaulting on meeting claims, and a resulting erosion of the industry’s reputation. The National Board of Revenue detected that most insurance companies are evading value-added tax and some have been served with demand notices, while others are facing investigation. The OCCI has issued show cause notice to a general insurance company to annul its license on allegation of insider lending by misusing paid-up capital through doling out advances to sponsors. The industry is constrained by limited possibilities for generating additional investment income from premiums received. At the end of 2004, the substantial reserves in the system (insurance investment was estimated at Tk313.8 million) are either deposited in banks or invested in government securities where the funds are not professionally managed under appropriate regulations. They could instead be used as long-term investment capital to stimulate economic growth.

According to the World Bank’s South Asia Bond Market report (footnote 31), only 5%–10% of the workforce is covered by formal retirement plans. These are primarily civil servants who participate in two types of retirement plans: a noncontributory, defined-benefit scheme, and a contributory provident scheme through the General Provident Fund. The report states that the provident fund “de facto operates as an unfunded system: contributions deducted from workers’ salaries are used to pay benefits, while the surplus is allocated to the budget.” These schemes are required to invest 75% of their assets in government securities. The report also states:

[40] The government is revising the Insurance Act 1938, to constitute a new insurance regulatory authority. Only after the authority is constituted will a decision be taken concerning to whom the authority will report.

State-owned enterprises and nationalized commercial banks also offer retirement plans. Pension plans offered by financial institutions are negligible, but large private firms have established pension schemes for their employees. Companies offer both defined-benefit and provident fund plans. These funds have traditionally invested in national savings certificates.

Both the regulators and regulated companies in this subsector recognize the severe capacity constraints of the supervision hierarchy, staff, and system. Additionally, the OCCI's Statutory Regulatory Order governing permissible investments by insurance companies is not streamlined.[41] The Sadharan Bima Corporation does not have a full-time managing director, as a competent person has not yet been found to take up the position.

Rural Credit, Microfinance, and Small and Medium-Sized Enterprises

Recent Developments

The member-based microfinance institutions constitute a rapidly growing segment of the rural financial market in Bangladesh; Grameen Bank is the only formal financial institution among them. It was established in 1983 under a special law with initial support from the Bangladesh Bank. Besides Grameen Bank, there are more than 1,000 semiformal institutions operating mostly in rural areas. The Bangladesh Rural Advancement Committee, the Association for Social Advancement, and PROSHIKA[42] (or Proshika centre for human development) are considered the three largest NGO microfinance institutions. These institutions have an explicit social agenda to cater to the needs of the poor, and have a focus on women clients.

The government has established the Microfinance Research and Reference Unit at the Bangladesh Bank to develop an appropriate regulatory and supervisory system for this subsector. A national steering committee was formed to administer the unit, formulate policy guidelines, and make suggestions for a regulatory framework. The committee completed its term in June 2005 but the unit is still active. Currently, the unit is working under the direct supervision of the governor of the Bangladesh Bank. The unit has already published operational guidelines for these NGO microfinance institutions with the help of the committee, and has been collecting half-yearly information since January 2004 on management, savings, credit, income, expenditure, and balance sheet items. The unit is also providing training to these institutions on the operational guidelines supplied to them. The Micro Credit Regulatory Authority was enacted on 16 July 2006 with effect from 27 August 2006. It is now an independent agency with a board of directors chosen from the government and the microfinance institutions. However, there is still room for improvement in regulatory compliance in the rural credit, microfinance, and small and medium-sized enterprises (SMEs) subsector.

Issues of Rural Credit, Microfinance, and Small and Medium-Sized Enterprises

Financial sustainability is a fundamental challenge for rural credit and microfinance institutions. The interest rates charged are high, although they are much lower than the 120%–300% charged by village moneylenders. NGOs usually charge 12%–15% interest per annum (all partners of the Palli Karma Shahayak Foundation[43] charge 12.5%) and microfinance

[41] Section 27 of the Insurance (Amendment) Act 2000 states that at least 30% of investible funds of life insurance companies (life funds) shall be invested in government securities and the balance can be utilized for any other investment, including capital market investments. The Federation of Bangladesh Chambers of Commerce and Industry has issued a notification dated 28 July 2002 specifying the list of investments for the balance assets (other than government securities). The list of investments allowed by the new statutory regulatory order seems to be impractical and restrictive. Only the ICB's unit funds, not private mutual funds, are allowed. Insurance companies are allowed to invest in shares and debentures of companies which are at least 25% owned by the government or public listed companies that have a record of dividend payments of more than 10% in at least 5 out of 7 years preceding the date of investment.

[42] PROSHIKA is an acronym of three Bengali words: *proshikkhan* (training), *shikkha* (education), and *kaj* (action).

[43] Since its inception in May 1990, the Palli Karma Shahayak Foundation has been working as an apex microcredit funding and capacity-building organization for eradicating poverty by providing microcredit to the poor through its partner organizations. Palli Karma Shahayak means "Rural Employment Support". The Palli Karma Shahayak Foundation has also expanded its operation to urban areas. So far the foundation has received funds from the government, the World Bank, the United States Agency for International Development (USAID), ADB, and the International Fund for Agricultural Development (IFAD).

institutions charge 20%–30% interest per annum. Microfinance institution borrowers place more value on reliability and accessibility and are not overly sensitive to the interest rate. NGOs depend on soft loans and grants from development partners for their funding (11% of total funds for onlending) and loans from the Palli Karma Shahayak Foundation (17%) in 2004.[44] It is challenging for rural credit and microfinance institutions to provide diversified services at lower prices while reducing financial dependence. There is a need to improve capacity of microfinance institutions and develop a sound policy and regulatory environment in order for them to be more efficient, free of distortion, and underpinned by sound financial practices.

The dominance of four large microfinance institutions has substantial implications for the poor. Most microfinance institutions are registered as societies, and the rest are registered as nonprofit companies, trusts, or cooperatives under different acts or ordinances. There is limited regulatory oversight of their activities. The regulation and supervision of a large number of microfinance institutions with heterogeneous features is a difficult task. A tiered approach is proposed by the World Bank to take into account differences in the organizational and operating characteristics of the various types of microfinance institution and their different levels of regulation and supervision.

Small and medium-sized enterprises (SMEs) are a critical component of the economy of any country. Bangladesh has been supportive of the subsector's development; however, the limited access of SMEs to finance has been identified by the government and the development community as a deterrent to sustainable long-term growth. Domestic financial institutions, microfinance institutions, and international agencies are the key players to improve the situation. According to the Bangladesh Bank, BASIC Bank in the public sector and BRAC Bank—a private commercial bank—are leading the way. Other financial institutions have opened special units to expand lending to SMEs to enable them to diversify their lending portfolio and expand into new business areas. The SouthAsia Enterprise Development Facility, managed by the International Finance Corporation (IFC), also plays a role in capacity building. In its 2008 report,[45] the Bangladesh Bank indicated that "the PCBs were the leader in providing SME loans with 54% of the total loan given to SMEs followed by SCBs (30%) and specialized banks (10%)." However, the report also says

> the current level of support is not adequate and the subsector needs more resources to support new and potential SMEs. Along with relatively high interest rates, collateral requirement is a major hurdle for SME entrepreneurs. Institutions to serve the subsector need to develop appropriate funding modalities that match the financing requirements of the clients along with their financial capacity to withstand potential lending risks and enhance productivity and efficiency of the SMEs.

The lack of credit support to SMEs is being addressed by the SouthAsia Enterprise Development Facility, and by ADB's SME sector development program loan (footnote 22). ADB also approved an SME Development Project in September 2009. The project encompasses provision of medium- to long-term credit to nonurban and rural SMEs.

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[44] Palli Karma Shahayak Foundation. 2005. *Credit and Development Forum, Microfinance Statistics*. Bangladesh.

[45] Bangladesh Bank. 2008. *Financial Sector Review*. Dhaka. (June issue).

Government's Financial Sector Strategy

To fulfill the vision of poverty reduction, four strategic blocks are identified by the National Poverty Reduction Strategy:[46] (i) enhancing pro-poor growth, (ii) boosting critical sectors for pro-poor economic growth, (iii) devising effective safety nets and targeted programs, and (iv) ensuring social development. The framework also identifies the following four supporting strategies or crosscutting issues: (i) ensuring participation, social inclusion, and empowerment of all sections, groups, and classes of people; (ii) promoting good governance by ensuring transparency, accountability, and rule of law; (iii) providing service delivery efficiently and effectively, particularly to the poor; and (iv) caring for the environment and sustainable development on a long-term basis.

The first three of the four strategic blocks require the financial sector to play a pivotal role in accelerating poverty reduction. To create an enabling macroeconomic environment for pro-poor growth the following are important:

(i) The financial sector must play a crucial role in achieving higher productivity by improving allocation of investment funds and strengthening the incentive framework and driving technological innovation, and eventually in increasing employment. The financial sector must support the higher investment levels required to meet the needs of the growing economy by mobilizing national savings, stimulating financial innovation, and complementing the bank-based system with a market-based system.

(ii) Monetary policy has to be underpinned by a sound and efficient financial system, as well as financial deepening to become effective in maintaining macroeconomic stability and in promoting a sound and stable environment for business and private sector activity to flourish.

(iii) The National Poverty Reduction Strategy pays special attention to two aspects of capital market operation: raising funds in a cost-effective manner, and enabling small savers to gain access to investment opportunities. It points out that restoring the confidence of entrepreneurs as well as savers requires an appropriate regulatory and technological infrastructure, diversification of instruments, as well as effective monitoring and supervision of various market participants by the regulatory authority.

(iv) To facilitate fair and competitive business, the financial sector, including SCBs and microfinance, must be properly reformed and supportive credit policies need to be established. The sale process of Rupali Bank was cancelled and the bank was given back to the government. Other SCBs have been transformed into public limited companies, although they are fully owned by the government. Enhanced accounting and stringent disclosure will be required for banks and nonbank financial institutions (NBFIs). Microfinance reform will include reaching the poorest of the poor at a reasonably low interest rate, and introducing an effective regulatory framework to ensure good governance and transparency of the activities of the participating institutions. Credit constraints of investors could be addressed by developing term finance, establishing a new agency for loan recovery, stimulating lease financing, and paying special attention to SMEs and women entrepreneurs. Promotion of secured financing (footnote 14) through the introduction of a secured transactions law will benefit SMEs in terms of enhanced credit delivery since SME debtors possess relatively little land but more movable property collateral.

[46] Footnote 2.

The second strategic block is closely linked to the first strategic block. The financial sector can boost critical areas for pro-poor economic growth such as SMEs in rural areas. Setting up an appropriate credit guarantee system for lending for otherwise creditworthy projects without real-estate-based collateral, and enlarging the base of conduit lending institutions, will benefit SMEs. Furthermore, the government has emphasized expanding credit flow to farmers and rural entrepreneurs. Effective financial institutions are also needed to tap small savings and remittances for productive investment, and a vibrant rural capital market should be developed.

In relation to the third strategic block, microcredit has been quite successful in raising the income of the poor and lowering overall poverty; however, there are limitations. The ultra-poor must be reached with microcredit through innovative approaches involving changes in credit delivery mechanisms, diversified financial services, and complementing microfinance with nonfinancial interventions. Microfinance needs to be scaled up to continue support to mature clients, new entrepreneurs, and tomorrow's poor. Since poverty will not be reduced by microfinance alone, microfinance institutions should integrate credit with technology, information, and marketing services. This will require them to pay more attention to risk management. The operational efficiency of microfinance institutions should also be improved through allowing flexibility in repayment rules, avoiding overlapping of credit disbursement, and rationalizing interest rates without compromising the main microcredit goals of community mobilization. Microfinance institutions may be allowed to borrow from organizations like the Palli Karma Shahayak Foundation or the general capital market if necessary. There should also be a regulatory framework that promotes transparency and accountability for savings mobilization and utilization. Lastly, to further empower women, more financial and nonfinancial support is needed for women to invest in rural enterprises and access marketplaces which are suitable to women.

As part of the third strategic block concerning the development of effective safety nets and targeted programs, the old-age pension scheme needs to be reviewed to extend its coverage. With regard to crosscutting supporting strategies, while all four strategies have implications for the financial sector, promoting good governance is particularly important. It includes reforms of banks, capital market, rural finance, and microcredit.

ADB's Development Experience

ADB's interventions.[47] ADB has long been concerned with the need to find the most appropriate ways to channel finance to productive enterprises in both the public and private sectors. Initially, ADB played a significant role in promoting the development of a leasing industry in Bangladesh. This flowed from a 1986 regional study of leasing[48] which recommended regulatory changes that ADB was subsequently instrumental in having enacted. This, in turn, was followed by ADB's financial backing for the creation of only the second leasing company in the country.[49] The World Bank has assumed the position of lead development partner in this area, with particular responsibility for the banking subsector, so ADB has, since 1993, taken on a specialist role in promoting the development and reform of the capital markets (i.e., securities markets). This has been done through the Capital Market Development Program (CMDP) (footnote 5) following the outbreak of the equity market scam in 1996, and through nine technical assistance grants totaling $7 million that were either preparatory for, or attached to, the program loan.

In addition to facilitating the provision of finance to enterprises, ADB has been promoting the development of pension funds with the aim of introducing more liquidity into the capital market. It has also been involved in creating a mechanism to provide retirement pensions both for the vast majority of the population who currently have none and for those public employees whose pensions constitute a growing burden for the state. Despite three technical assistance projects related to the subject, efforts to advance this agenda have made little headway because it is not considered a current government priority, regardless of its long-term implications.[50]

Key lessons. The CMDP addressed the need to strengthen market regulation and supervision and develop the capital market's infrastructure and support facilities. It also addressed issues relating to the supply of and demand for capital market instruments arising from the domestic stock market crisis. This crisis was widely attributed to wrongdoings by brokers, and although several have been charged in court, no convictions have so far resulted.[51] Consequently, the reform program is perceived by market intermediaries and stakeholders—mainly the Dhaka Stock Exchange (DSE) brokers—as being concerned more with strengthening the Securities and Exchange Commission (SEC) and the regulatory environment, rather than having a direct benefit to or impact on the market. Some of the actions and measures are being debated and there are calls for impact assessment and review,[52] as well as further interventions for capacity building and streamlining. On the other hand, several stakeholders, including the SEC, have expressed the need for further interventions

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47 Based on ADB. 2003. *Country Assistance Program Evaluation for Bangladesh*. Manila.

48 ADB. 1996. *Study of Leasing in Selected Developing Member Countries (Supplementary).* Manila.

49 ADB. 1989. *United Leasing Company.* Manila.

50 There is no mention of pensions (funded or otherwise) as a priority issue in the Fifth Five-Year Plan. Implementation of the latest technical assistance project (ADB. 2000. *Technical Assistance to the People's Republic of Bangladesh for Capacity Building of the Securities and Exchange Commission and Selected Capital Market Institutions.* Manila.) intended to prepare a project, or possibly program, loan has been deferred pending further clarification of the government's intent.

51 The Capital Market Development Program was mounted in direct response to a request by the then finance minister of the Government of Bangladesh for assistance in dealing with the crisis in the domestic capital market.

52 ADB undertook a program completion review of the Capital Market Development Program loan in October 2002 and assessed the program *partly successful*. The program completion report was finalized in July 2003. The project performance audit report was finalized in August 2005.

for capacity building and streamlining of laws, rules, and procedures. Others have argued for a shift in the focus of any future program for the capital market to assisting the capital market intermediaries in product development. The successor project[53] of the CMDP has components that would extend its impact beyond the achievements of its predecessor.

In the context of capital market reform in Bangladesh, careful consideration was given to the complex capital market, the large number of vested interests involved, and the weak governance climate. It would thus be appropriate to view the process of capital market reform as a long-term one, in which ADB needs to promote policy dialogue, backed up by the requisite technical assistance projects. However, the experience of the stock market crash shows that the resolve to make reforms weakens as the pressure to undertake them diminishes. Consequently, further policy lending in the capital market should only be considered where strong government commitment to meaningful reform has been demonstrated by unequivocal up-front action.[54]

The reforms recommended by the program performance audit report[55] on lessons learned from the CMDP are as follows:

(i) To establish a market-friendly regulatory framework, an oversight institution (as well as ADB) should consider both benefits and costs associated with the rules and regulations, based on broad consultation with stakeholders. The segregation of financial intermediaries pursued under the CMDP reaffirmed the importance of consultation as a consideration in formulating recommendations. The size, depth, and liquidity of the market; the capacity of market intermediaries; the quality of financial statements; the soundness of corporate governance practices; and experiences of other countries may constitute key elements for consideration.

(ii) A comprehensive reform program can be feasible only of it is an integral part of the government-owned long-term development strategy linking the reforms of all concerned subsectors over time. To support such a long-term effort of the government, ADB needs to realistically prioritize reform measures and set timelines while considering the capacity of implementing agencies. The number of program measures should be limited so that ADB can monitor compliance with them throughout the program. Flexibility would also be needed during implementation in adjusting agreed reform measures, on the basis of immediate program outputs and outcomes as well as external factors. A program cluster approach may be more appropriate than conventional program lending.

(iii) The counterpart funds of the CMDP were not allocated in the loan agreement. ADB, for its part, did not closely monitor the actual program cost and did not pay sufficient attention to funding constraints that the implementing agencies faced. Consequently, some of the stakeholders felt that there was no accountability in the use of the counterpart funds of the loan. When a reform is associated with a definite and significant amount of investment, a sector development program may be more appropriate than a program loan. To support institutional capacity building, a technical assistance grant or loan in some cases could be just as appropriate as a program lending intervention.

(iv) Despite the substantial support from ADB since 1993, effective institutional frameworks to govern insurance and pension reforms are not yet in place due to weak government commitment. Considering this track record, ADB's future assistance to these areas should be conditional upon major progress in reforms rather than an advance agreement.

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53 ADB. 2006. *Technical Assistance Loan to Bangladesh for the Financial Markets Governance Improvement.* Manila. This seeks to develop the legal, regulatory, and institutional aspects of the domestic financial market. The program will promote and enhance financial market governance across all market segments, encompassing the regulators, market players, listed companies, and issuers of securities. This is essential for building investor confidence and improving the process of financial intermediation in Bangladesh.

54 An independent report by ADB's Operations Evaluation Department also contains this recommendation.

55 ADB. 2005. *Program Performance Audit Report on the Capital Market Development Program.* Manila.

Clearly, the program performance audit report reform actions and perceived process are prescriptive of reforms undertaken under stable and orderly market conditions such that an oversight institution—the SEC—with the requisite capacity could undertake the necessary consultations. Under crisis conditions, however, this may not always be possible. In fairness, it should be recognized that the SEC was only newly established at that time, its operations were rudimentary, and its capacity was very limited. In terms of its budget, the SEC (i) did not have the luxury of time to consider benefits and costs of associated regulations, the practice of regulatory impact assessment having been introduced only in recent years in some jurisdictions; (ii) could not have the benefit of a government's long-term development strategy as none was in place; and (iii) needed urgently to stop the hemorrhage in the stock market and address pressing investor concerns. This set of circumstances accounts for the subsequent extensive technical assistance given to the SEC by ADB. However, the current criticism that the SEC is over-regulating is an indication that it needs further support in terms of rule making, particularly in stakeholder consultation. However, the government now fully recognizes the need to have a long-term development strategy and this has been incorporated into its National Poverty Reduction Strategy.

It should also be noted that ADB's intervention had the full support of the donor community in Bangladesh. Prior to undertaking the reform program, a donor's meeting was held with the government, in which donors agreed to have ADB take the lead in helping to resolve the crisis. The United Nations Development Programme (UNDP) provided immediate technical assistance, administered by ADB, pending approval of ADB funding. The United States Agency for International Development (USAID) subsequently took over from UNDP and provided experts to guide the SEC. Extensive consultation was also undertaken with major stockholders, both of the local exchanges, and the local chambers of commerce and industry.

There was no earmarking of counterpart funds which is a recent phenomenon in program lending, as in the past this was considered interference with the government's internal budget process. The current trend in program lending is also not supportive of earmarking procedures. On the other hand, the criticism that there was no accountability in the use of counterpart funds came mainly from members of the DSE who wanted capacity building and other forms of support from ADB. Considering that they were at the center of the controversy, they were expected to bear the brunt of reforms. Moreover, being a private sector entity, the DSE is not eligible for support through ADB's public sector window except through the government.

Several points are clear in the context of the country:

(i) Not only commitment but also full authority and control in pursuing reforms are necessary where vested interests and turf issues are major factors within the bureaucracy.

(ii) Where governance is weak, very close supervision is necessary to ensure proper implementation; thus, either staff skills at the resident mission are made available or external consulting services are provided.

(iii) Long-term follow up is crucial to sustaining a process as complex and long as capital market development in a country where the private sector remains small and poverty is widespread.

(iv) Parallel reforms are important to the process, especially in building the private sector (ADB has initiated programs for SMEs to help develop the subsector) and improving governance (critical to enhancing investor confidence; ADB has a far-reaching anticorruption and governance reform program in place).

If ADB wants to provide projects based on lines of credit or other forms of loan finance, it should be more actively engaged in improving regulation and transparency in the banking subsector, notwithstanding the World Bank's established role as the lead development partner, and considering that the World Bank has recently started to get involved in capital market development. In particular, the aim should be to eliminate cartel-like practices that have reportedly resulted in excessively high real interest rates which favor depositors rather than borrowers and also enable banks effectively to cross-subsidize nonperforming loans (NPLs).

Activities of Other Development Partners

A number of donors are assisting the government in various facets of the financial sector. Increasing overlap between subsectors within the financial sector cannot be avoided due to its inherently intertwined nature, with accounting and auditing, governance, and issues of rules and regulation and infrastructure development cutting across the board. In the past, the World Bank focused on banking subsector restructuring and capacity-building assistance to the Bangladesh Bank;[56] the International Monetary Fund (IMF) on assistance in macroeconomic, monetary, and fiscal management; and ADB on securities market–related reforms. (The appendix lists the financial sector projects of development partners in Bangladesh.)

While ADB continues to be the lead funding agency in the capital market, the IMF and the World Bank have also been involved in bond market development related to effective monetary policy. Recently, the World Bank has been more active in securities markets, developing primary and secondary government bond markets, and the corporate bond market. ADB is also playing a lead role in dealing with various governance issues, including the establishment of anticorruption measures and the introduction of a secured transactions law. The Financial Sector Reform and Strengthening Initiative (FIRST) recently provided technical assistance to the insurance subsector.[57]

The 2003 joint IMF and World Bank financial sector assessment of the financial markets emphasized reforms in the banking system to contain the risk of systemic distress. The World Bank and ADB have jointly assisted the government to finance the private sector through improved financial market access for SMEs, particularly the so-called "missing middle," between micro and medium-sized enterprises. The World Bank is reforming the SCBs under its Enterprise Growth and Bank Modernization Project and the Second Development Support Credit.[58] It is also supporting the Bangladesh Bank's dual role as the country's monetary authority and bank regulator and supervisor as part of the Central Bank Strengthening Project.[59]

In May 2006, the World Bank approved the $50 million Investment Promotion and Finance Facility Project.[60] The objective of this project is to increase competition and transparency in infrastructure finance through

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56 E.g., World Bank. 2000. *Financial Institutions Development Project.* Washington, DC. ($57.7 million); World Bank. 2003. *Central Bank Strengthening Project.* Washington, DC. ($37 million); World Bank. 2004. *Enterprise Growth and Bank Modernization Project.* Washington, DC. ($172.3 million); and World Bank. 2004. *Economic Management Technical Assistance Program.* Washington, DC. ($20 million).

57 The Insurance Law Reform Project (2003) of FIRST has provided recommendations for insurance subsector development as well as inputs for the draft insurance act. FIRST is a $53 million multidonor program (there were seven donors in 2004) to support capacity building and policy development projects in the financial sector. FIRST provides technical assistance grants for short- and medium-term projects in the areas of financial sector regulation, supervision, and development.

58 World Bank. 2004. *Enterprise Growth and Bank Modernization (EGBM) Project.* Washington, DC. The EGBM project continues the restructuring support of financial and nonfinancial state-owned enterprises (SOEs) that began with the June 2003 Development Support Credit. The project has a component "Resolution of the Problems of the State-owned Commercial Banks" budgeted for $34 million out of a total loan of $250 million. The next phase of SOE reform is also being implemented under the Second Development Support Credit (2004), the key support areas of which include preparation for management support for some SCBs and issuance of prudential regulations; and supporting actions in a number of governance areas such as anticorruption initiatives, accounting, and auditing.

59 World Bank. 2003. *Central Bank Strengthening Project.* Washington, DC. This project supports implementation of Bangladesh Bank's strengthening program by providing assistance in three major areas: legal framework, reorganization and modernization, and capacity building.

60 World Bank. 2006. *Investment Promotion and Finance Facility Project.* Washington, DC.

supporting private sector participation and market-based solutions. It will supplement the resources of Bangladesh's financial markets to provide long-term finance for infrastructure projects beyond the capacity of local financial institutions. The Government is also seeking to leverage its own resources by fostering innovative ways to involve private partnerships in the financing, development, management, and servicing of economic zones in nonmetropolitan areas through the World Bank's $150 million Private Sector Development Support Project.[61] Economic zones address key competitiveness issues facing firms (including SMEs) by providing serviced land, reliable infrastructure, adequate logistics, and an authority that attends to the needs of the zone's tenants.

Substantial investment is required to restore the health of the banking system and remedy the pervasive governance issues that impact the entire financial sector as well as corporate enterprises. Therefore closer donor coordination is necessary in possible areas of obfuscation and contention to avoid overlap in program design and structure. While the first steps in this direction have been initiated under IMF and World Bank policy-based loans (the Poverty Reduction and Growth Facility, footnote 11), the ultimate costs of reforming and restructuring the distressed banks are conservatively estimated to be around 6%–8% of GDP.

From an operational perspective, coordination amongst the development partners and ADB can be conceptualized as follows: ADB needs to continue to play a lead role in the development of the securities market and in support of the government's Medium Term Macroeconomic Framework by filling the resource gap. Considering the substantial issues that need to be addressed in order to enhance financial services, there is room for ADB to cooperate with other development partners in areas beyond the securities market. In view of the success of microfinance in Bangladesh, any intervention in this area will be limited to promoting competition and enhancing the stability of microfinance institutions. There is plenty of room to intervene in nonbank financial institutions (NBFIs), if resources are available.

A 15-year sequencing of framework parameter reforms, specifically the securities and banking markets, is illustrated in Table 7. The table provides an assessment of the ongoing financial sector reforms in Bangladesh, taking stock of work that remains to be accomplished, and gives an indication of the time frame to achieve critical reforms, mainly in the securities and banking subsector. The 15-year reform framework envisages the development of a sound, market-oriented financial system, characterized as competitive, integrated, efficient, and capable of facilitating domestic resource mobilization and growth-oriented investment.

Successful implementation of the reform framework depends on strong leadership and firm commitment from the government. It also calls for the timely assistance of international aid agencies as a source of technical and financial resources for successful implementation of the reform framework. Continuous refinement and updating of the framework based on the progress made and the changing socioeconomic environment will enable the government to maintain momentum in its development efforts, and will facilitate coordination among international aid agencies.

[61] World Bank. 2006. *Private Sector Development Support Project*. Washington, DC.

Table 7: Sequencing of Framework Parameter Reforms

(An issue in italics indicates its reform is currently in progress in Bangladesh)

Regulations and Supervision	Standards and Codes	Capital Market Development	Market Deepening and Reforms
Phase I (Initiating Phase: immediate 5 years)			
Increased capacity and greater autonomy to Bangladesh Bank with legislation drafted and passed *New prudential regulations drafted and passed* *Strengthening related banking legal and judiciary processes* Development of legal/regulatory and incentive framework for nonbanking areas of securities market, insurance and pensions, and rural and microfinance Connected and directed lending stopped *Develop policies for restructuring/privatizing SOEs* *Secured transactions law adopted* Strengthen debt recovery framework and enforcement Regulation on unfair trading strengthened Improve exchange regulations, supervision, and compliance	*Relevant accounting and auditing standards strengthened to conform with international standards* Initiate corporate governance practices in public enterprises, including SOEs and SCBs Overall institutional capacity in formulating and implementing the above policies and guidelines strengthened Disclosure requirements implemented Standards on market trading developed and established	Develop and strengthen public debt policy and management including treasury operations, integrated into a broader fiscal framework *Expand short-term government securities market operation and further develop network of primary dealers* Accelerate development of money market by expanding network of financial intermediaries engaged in underwriting and syndications, securities trading, dealership, and brokerage. Develop government and corporate bond markets Rationalize and demutualize stock exchanges	Strengthen existing SOE/SCB structures and operations in preparation for further privatization/divestiture *Revisit continued government presence in the private sector and reduce NPL level and improve market efficiency* Expand new market-based financial instruments and products such as commercial papers, negotiable certificates of deposit, and bills of exchange that meet market needs Strengthen Credit Rating Agency of Bangladesh to aid the development of money market and other longer-term capital market instruments Improve existing payment and settlement system to ensure safe and secured payments and settlements and reduce the gap between payments and settlement *Increase lending to SMEs, particularly the "missing middle" and contribution to refinancing facility*
Phase II (Developing Phase: subsequent 5 years)			
Basel II fully integrated into banking operations	Code of good corporate governance mainstreamed in SOEs and large public enterprises	Expansion into longer-term government bonds and their secondary market initiated and introduced	Further privatize SOEs

NPL = nonperforming loan, SCB = State-owned commercial bank, SMEs = small and medium-sized enterprises, SOE = state-owned enterprise.

continued on next page

Table 7 continued

Regulations and Supervision	Standards and Codes	Capital Market Development	Market Deepening and Reforms
Policies and regulations on other nonbanking areas and institutional reform, such as in leasing and housing finance, strengthened	Accounting and auditing standards relevant to the country's stage of development fully developed and conform with international standards Overall institutional capacity in formulating and implementing the above policies and guidelines developed Disclosure requirements fully adopted Standards on market trading strengthened	Stock exchange information dissemination and modernized trading architecture developed Further privatization of public enterprises and push for IPOs of large firms, including foreign enterprises with operations in Bangladesh, to increase supply of securities in the market Institutional investments promoted Promotion of asset-backed securities market through the introduction of a securitization law	Bank restructuring/ recapitalization, with government bank ownership substantially reduced, and entry of new domestic/foreign banks and associated new services accelerated Complete enterprise restructuring/ privatization, with relevant SOEs and SCBs privatized Undertake reform of the ICB and its act to divest the government holdings in the ICB and its subsidiaries to provide a level playing field, promote competition, and facilitate the growth of institutional investors and the mutual fund industry
Phase III (Final Phase: last 5 years)			
Fully modernized regulatory and supervisory structure and system in line with international standard-setting organizations Effective monitoring mechanism and full compliance	Code of good corporate governance mainstreamed in all public and publicly listed entities Accounting and audit practices conform fully with international standards (including disclosure requirements), and accountability mechanisms are put in place. Capacity development in above areas sustained Standards in market trading conform with international best practices	Encourage development of secondary and long-term debt securities markets Incorporation and integration of the capital markets into regional markets Full participation in capital markets of retail investors, SMEs, and other smaller players Introduction of derivative instruments and strengthening of securitization capacity	Operation of more integrated financial institutions offering diversified market services Market-based and transparent decision-making mechanisms to build confidence in the financial sector Modern trading and information system infrastructure for financial transactions in place Restrict the government presence only in areas where private sector does not operate.

ICB = Investment Corporation of Bangladesh, IPO = initial public offering, SCB = state-owned commercial bank, SMEs = small and medium-sized enterprises, SOE = state-owned enterprise.
Note: Capacity building and human resource development are relevant to all phases.

Parallel Reforms to Ensure Financial Sector Development

Financial sector reforms need to be complemented by parallel reforms to ensure financial sector development. Parallel reforms would encompass (i) private sector development; (ii) good governance, particularly in enhancing transparency and information disclosure and dissemination; and (iii) capacity building among the regulator, market participants, and professionals, including accountants and auditors.

Private sector development. The growth of the financial markets critically depends on the development of the country's private sector which would form the base of investors and issuers in the market. The emergence of an enabling environment within which the private sector can thrive, unhampered by administrative fiat and other constraints, is a necessary prerequisite to better resource mobilization and more efficient intermediation. Donor projects geared to this purpose are supported by various agencies—including ADB, the Department for International Development of the United Kingdom (DFID), the Japan International Cooperation Agency (JICA), and the World Bank—addressing structural and institutional barriers to private sector development. Donor assistance demands close coordination to leverage the respective resources available and should capitalize on comparative advantage to maximize development effectiveness. In addition to assistance from ADB and the World Bank, DFID is working with the International Finance Corporation (IFC) on the Business Investment Climate Fund[62] to improve business regulations and reduce red tape and corruption. This fund will complement the World Bank's $150 million Private Sector Development Support Program[63] which will make significant investments in special economic zones to promote specific growth sectors.

In May 2006, the World Bank approved the $50 million Investment Promotion and Finance Facility Project (see discussion under Activities of Other Development Partners) to increase competition and transparency in infrastructure finance through supporting private sector participation and market-based solutions. It will supplement the resources of Bangladesh's financial markets to provide long-term finance for infrastructure projects which are beyond the capacity of local financial institutions. ADB, for its part, provided a $165 million Public–Private Infrastructure Development Facility in September 2008. The facility is designed to promote public–private partnerships in infrastructure finance and catalyze infrastructure debt financing, renewable energy financing, and project financing, which will be coursed through the Infrastructure Development Company Limited. This state-owned company was chosen as the appropriate vehicle to introduce and expand public–private partnerships and is the only financial institution in the country mandated and specialized in these fields. This will also complement the World Bank's Investment Promotion and Finance Facility Project. Together these projects will improve the country's infrastructure and increase private sector participation, leading to greater economic efficiency and growth.

Good governance. One of the main constraints to stronger financial intermediation in Bangladesh is poor governance. The stock market crisis of 1996 was precipitated by anomalies in stock market transactions, although no one has been brought to task for them. This has resulted in a low level of investor confidence. The $150 million ADB Good Governance Program for Bangladesh introduces governance reforms through a broad and comprehensive approach. The objectives of the program are to (i) strengthen the ongoing consensus building on good governance, integrity, and

[62] IFC. 2007. *Business Investment Climate Fund*. Washington, DC.

[63] Footnote 61.

anticorruption reforms; (ii) support judicial reforms which emphasize the performance, transparency, and accountability of the judiciary, particularly in its role in the anticorruption agenda; (iii) strengthen the role and reach of the Anti-Corruption Commission so that it can fight corruption more effectively; and (iv) bring good governance and anticorruption initiatives into the mainstream within selected sector agencies to enhance their effectiveness. In the medium term, the program will institute a system of good governance upon which a strong basis for more rapid and inclusive growth can be established. This, in turn, is expected to directly contribute to a situation where foreign direct investments, and other associated benefits, will increase. In 2004, for example, the Australian Agency for International Development (AusAID) provided computerization and e-governance systems through IFC's SouthAsia Enterprise Development Facility to the Registrar of Joint Stock Companies and Firms of Bangladesh.

Capacity building. To improve the depth and breadth of the financial sector, a key foundation is upgrading of the technical know-how of stakeholders through capacity development. Continuous efforts should be built on prior and ongoing ADB interventions, such as in the Financial Market Governance Program.[64] This program targeted the improvement of investor confidence, by enhancing financial regulatory and supervisory capacity through developing market knowledge, institutional capacity, and skills of market participants. Furthermore, under the World Bank's $200 million Second Development Support Credit Project,[65] approved in July 2004, measures include strengthening the independence of the auditor general and resolving serious audit irregularities raised by the Public Accounts Committee. The committee has subsequently taken steps to introduce greater transparency in public accounting and tighten auditing. The momentum from these capacity-development initiatives needs to be adequately maintained.

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64 ADB. 2003. *Technical Assistance to Bangladesh for Financial Markets Governance Program.* Manila.

65 World Bank. 2004. *Second Development Support Credit Project.* Washington, DC.

ADB's Financial Sector Strategy for Bangladesh

Results-based approach. The key objective of financial sector assistance in Bangladesh is to help transform the sector into an effective purveyor of financial services. As such the sector can support economic development and improve access to finance in order to promote inclusive growth and thereby reduce poverty. The medium- to long-term financial sector strategy adopts a results-based approach in line with the country strategy and program.[66] To maximize the impact of the assistance, issues will be prioritized through three steps: (i) sequential urgency for the provision of efficient financial services with a long-term perspective as well as government commitment and ownership as declared in the National Poverty Reduction Strategy; (ii) ADB's comparative advantage and initiative in a sector or subsector, and coordination among development partners; and (iii) prioritization based on strategic assessment and resource constraints. ADB has achieved considerable success in its areas of comparative advantage for financial sector assistance in developing member countries. For example, ADB's securities market development programs in India and Pakistan resulted in more efficient resource allocation through increased reliance on market mechanisms as well as improved ability to mobilize internal and external resources.

Accordingly, ADB will formulate a series of well-coordinated lending and nonlending programs taking into account key sector-wide issues. ADB will expand its main focus from securities market interventions to cover other subsectors, including rural credit, microfinance, and private sector—particularly small and medium-sized enterprises (SMEs)—development through improved access to finance, as well as better governance through policy and institutional reforms in the banking subsector where needed. This will be done in close coordination with the International Monetary Fund (IMF), the World Bank, and other development partners. Eventually, future interventions will be needs driven and flexible, so as to provide appropriate assistance as the domestic and global environment changes.

The proposed interventions (see section on Summary of financial sector issues and ADB interventions and Table 8) will provide improved financial services as well as alternative sources of long-term finance. The sector outcomes are improved financial services supported by increase in savings mobilization and investment (i.e., domestic investment, foreign direct investment, and portfolio investment),[67] improvement in corporate governance, provision of risk management services, and enhancement of liquidity in the markets.

Promotion of good financial market governance. ADB will assist the government in promoting good financial market governance by (i) enhancing regulatory and supervisory capacity and improving the regulatory and enforcement process; (ii) strengthening the legal and regulatory framework, in particular by establishing a secured transactions regime[68] and a sound debt recovery framework to support ongoing reform of the banking subsector, facilitate speedy resolution of nonperforming loans, and promote

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66 ADB. 2005. *Country Strategy and Program* (2006–2010). Manila.

67 Portfolio investment would be enhanced with the promotion of good financial market governance and increasing the supply of quality listed shares, such as through privatization of state enterprises through public share offerings. In addition to ADB's interventions to promote good financial market governance and addressing extraordinary demand for financial services, the present government's diligent efforts to clamp down on corruption and ensure consistency and predictability over economic policies should stimulate foreign direct investment.

68 The Secured Transaction Law was drafted under ADB. 2003. *Technical Assistance to Bangladesh for Supporting Good Governance Initiatives.* Manila.

greater private sector investment in the financial sector;[69] (iii) improving the governance and operations of market intermediaries, including microfinance and rural finance institutions; (iv) rationalizing securities-related laws, rules, and regulations; (v) increasing transparency and ensuring full public disclosure and the wide dissemination of market information; (vi) deepening the financial markets by assisting in the development of diversified market instruments that appropriately meet investor and issuer needs for hedging risks, and credit mechanisms that mitigate risks like guarantees; (vii) enhancing market knowledge, institutional capacity, and skills of market participants; and (viii) strengthening coordination between regulators (e.g., the Bangladesh Bank, the Securities and Exchange Commission [SEC], and the OCCI) to ensure complementary development of markets and coordinated risk management and prevention, particularly systemic risks.

Development of domestic securities market. ADB will help the government to further develop the country's domestic securities market by (i) strengthening the market and governance structures; (ii) enhancing the support infrastructure through activities such as the operation of central depositories, accounting and audit in collaboration with other donors, and systems of disclosure and information dissemination; (iii) promoting the development of sources of institutional investments, such as insurance companies, pension and provident funds, mutual funds, and venture capital; (iv) developing the secondary market for securities by facilitating the development of a domestic money market, in particular the government and short-term corporate securities market, and eventually the long-term debt markets; (v) creating an enabling environment for issuance of quality securities; (vi) encouraging a rationalization of the interest rates of government savings schemes and addressing other market frictions that constrain securities market development; (vii) introducing an active derivative market for risk management with forwards, futures, and options contracts for foreign exchange and interest rate risks; and (viii) assisting merchant banks and brokerage houses in building capacity to exercise due diligence of companies to improve the process for initial public offerings (IPOs).

Summary of financial Sector issues and ADB interventions. The financial sector issues and ADB's strategic intervention areas are summarized in Table 8 by pillar and subsector.

Comprehensive donor intervention in the financial Sector. The policy reform matrix outlined in Table 7 and the proposed ADB intervention set out in Table 8 envisage the development of a sound market-oriented financial system within 15 years. The system is characterized as competitive, integrated, and efficient, which will facilitate domestic resource mobilization and growth-oriented investments. Continued policy dialogue is a prerequisite and the ownership of each program and project should lie with the government. Such reform measures and targets should be realistic and manageable within the range of acceptance by the political leadership and bureaucracy. Flexibility would be needed during implementation to adjust agreed reform measures on the basis of immediate program outputs and outcomes, as well as external factors. For this type of support, a program cluster approach,[70] rather than a conventional program loan, may be more appropriate.[71]

There should be awareness building on the potential dangers in delaying reforms and the futility of proceeding on an as-is basis, which has caused mounting losses and inefficiency in the state-owned sector. The Financial Institutions Development Project of the World Bank, and ADB's Capital Market Development Program, followed by the financial markets governance project, have set the tone for the reforms and paved the way for the future action agenda. This will act as a facilitating factor in risk minimization. An additional risk minimization factor to consider would be the introduction of local currency loans in Bangladesh by ADB to help borrowers avoid currency mismatches in projects earning revenue in local currency.

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69 For a comprehensive discussion, refer to section on Results-based approach on private sector development. Despite its recognition of the private sector as the engine of economic growth, the Interim National Poverty Reduction Strategy does not define instruments to develop the private sector.

70 ADB introduced the program cluster approach on 1 January 2000 as an extension of program lending to enhance flexibility and extend the time frame (4–7 years) for program implementation.

71 ADB. 2005. *Project Performance Audit Report on the Capital Market Development Program in Bangladesh.* Manila.

Table 8: Summary of Financial Sector Issues and ADB Interventions

Subsector	Pillar		
	Governance	**Support Infrastructure**	**Market**
Sectorwide	• Lack of secured transactions law • Contribution to anticorruption, and establishment and implementation of law and order	• Weak information system	• Limited role of the financial sector in resource mobilization and allocation • Market segregation and uneven liquidity distribution • Lack of coordination among regulators
Banking	• SCB reforms • Weak debt recovery framework • Low efficiency • Lack of best practice	• Lack of NPL resolution agencies • Inefficient payment system	• High interest rates • Limited long-term financing • Low internal risk management
Securities Market	• Gaps in legal and supervisory framework	• Underdeveloped credit rating system/credit enhancement system • Underdeveloped special purpose vehicles for asset-backed securities • Inefficient clearing and settlement system	• Rationalization of stock exchanges • Shortage of quality securities • Reluctance of large pubic and private entities to issue IPOs • Lagging development of government bond market • Lack of demand for debt securities • Rudimentary secondary markets • Underdeveloped asset-backed securities • Incomplete reform of the ICB • Weak role of other market participants • Low due diligence capacity • No derivative market for hedging and risk management • Lack of securitization mechanism for remittances and infrastructure revenues
Insurance and Pension	• Weak regulatory framework		• Shortage of funds
Rural and Microfinance and SMEs	• Weak regulatory framework		• Weak sustainability • High dependency • Limited SME financing

ICB = Investment Corporation of Bangladesh, IPO = initial public offering, NPL = nonperforming loan, SCB = state-owned commercial bank, SMEs = small and medium-sized enterprises.

Note: The gray part indicates ADB's primary strategic coverage.

Monitoring and Implementation Issues

Changes in political commitment, a difficult political economy, and weak institutional capacity of executing agencies often frustrate implementation of financial sector assistance. Given the importance of consensus building and the government's commitment and ownership, ADB will closely monitor the political situation and adopt a flexible approach to maximize assistance results. Reform components must be carried out with stakeholder consultation, particularly with the active participation of the private sector. In addition, new involvement in the financial sector with respect to the state-owned commercial bank (SCB) reforms requires closer coordination with the World Bank and the IMF. The capacity of executing and implementing agencies can frequently be a constraint to project implementation in Bangladesh; therefore, when weak capacity is identified as an issue, capacity-building components will be modified and strengthened wherever the project costs allow. Outputs, progress achieved, and lessons drawn from the implementation of the Small and Medium Enterprise Sector Development Program (footnote 22) and the technical assistance for financial markets governance (footnote 53) improvement will guide the design of future financial sector and SME development support for the financial sector and SMEs.

Appendix

Financial Sector Projects of Development Partners

Pillar	ADB	Other Development Partners
Governance	Capital Market Development Program (1997) • Strengthening the SEC • Upgrading accounting and auditing standards Technical Assistance (TA) 4140: Supporting Good Governance Initiatives (2003) • Drafting of secured transactions law TA 4246: Financial Markets Governance Program (2003) • Strengthening debt recovery • Strengthening corporate governance and public disclosures Loan: Financial Markets Governance Improvement TA Loan (2005) • Enactment of secured transactions law • Development of measures to strengthen market discipline and regulators • Development of debt recovery system	Financial Institutions Development Project (World Bank, 1999) • Development of issue rules of bonds and debentures • Reform of National Savings Schemes Legal and Judicial Capacity Building Project (World Bank, 2001) • Improvement of access to justice, including development of alternative dispute resolution mechanism and strengthening of small cause courts Financial Sector Reform and Strengthening Initiative (FIRST, 2002) Reforms in Revenue Administration (DFID, 2002) Central Bank Strengthening Project (World Bank, 2003) • Strengthening the legal framework • Functional reorganization Insurance Law Reform Project (FIRST, 2003) • Drafting Insurance Law Financial Management Reform Program (DFID, 2004) Economic Management TA Program (World Bank, 2004) • Strengthening accounting and auditing practices in the corporate sector Poverty Reduction and Growth Facility (IMF, 2003) and Development Support Credit[a] (World Bank, 2003, 2004. and 2005) • Reforms in the banking subsector Enterprise Growth and Bank Modernization (World Bank, 2004) • Resolution of problems of the SCBs Private Sector Development Support Project (PSDSP) (World Bank, 2006) • streamlining the regulatory interface between government and business

DFID = Department for International Development of the United Kingdom, IMF = International Monetary Fund, SCB = state-owned commercial bank, SEC = Securities and Exchange Commission.

[a] To support the implementation of the National Poverty Reduction Strategy.

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Appendix continued

Pillar	ADB	Other Development Partners
Support Infrastructure	CMDP (1997) • Automated central depository system • Automated trading system	Remittance and Payments Partnership Project (DFID, 2007) • Modernization of payment system Central Bank Strengthening Project (World Bank, 2003) • Automation Private Sector Development Support Project (PSDSP) (World Bank, 2006) • facilitating the focused provision of land and infrastructural services through an efficient industrial zoning program
Market	CMDP (1997) • Enhancing accountability and improving operations of stock exchanges • Rationalizing brokers, dealers, merchant banks, and other capital market participants • Divesting government shares in SOEs • Strengthening contractual savings institutions TA 4104: Assistance to the Privatization Commission (2003) • Divestment of shares through public offering and listing on the stock exchanges SME Sector Dev Program (SMESDP, 2004) • Contribution to refinancing facility TA 4246: Financial Markets Governance Program (2003) • Improving operations of market intermediaries • Deepening of the demand and supply of capital market	FIDP (World Bank, 1999) • Establishment of a secondary treasury bill market (with US and IMF) • Creation of Credit, Bridge and Standby Facility to encourage the development of term financing Second Poverty Alleviation Microfinance Project (Microfinance II) (World Bank, 2001) • Expansion of rural and urban microcredit Financial Services for the Poorest (World Bank, 2002) • Finance revolving fund for microcredit extension Enterprise Growth and Bank Modernization (World Bank, 2004) • Contribution to refinancing facility Investment Promotion and Financing Facility (IPFF) (World Bank, 2006) • Contribution to a Market Based Fund and a Capital Grant Fund to finance infrastructure and other term investment projects
Capacity Building[b]		Legal and Judicial Capacity Building Project (World Bank, 2001) • Judicial capacity building Reforms in Revenue Administration (DFID, 2002) Central Bank Strengthening Project (World Bank, 2003) • Human resources development program and capacity building

CMDP = Capital Market Development Program, DFID = Department for International Development of the United Kingdom, FIDP = Financial Institutions Development Project, IMF = International Monetary Fund, SMESDP = Small and Medium Enterprise Sector Development Program, SOE = state-owned enterprise, TA = technical assistance, US = United States.

[b] Capacity building is a crosscutting pillar, therefore each project not in this row also has a component of capacity building.

continued on next page

Appendix continued

Pillar	ADB	Other Development Partners
		Capacity Bldg for Capital Market Intermediaries (FIRST, 2004) • Development of sustainable training program Enterprise Growth and Bank Modernization (World Bank, 2004) • Capacity building of Privatization Commission Private Sector Development Support Project (PSDSP) (World Bank, 2006) • Capacity building in key government agencies working on private sector development issues Economic Management TA Program (World Bank, 2004) • Strengthening capacities of Bangladesh Bank, the SEC, and Department of Insurance on accounting and auditing practices

FIRST = Financial Sector Reform and Strengthening Initiative, SEC = Securities and Exchange Commission, TA = technical assistance.

Bangladesh Financial Sector An Agenda for Further Reforms

The finance sector in Bangladesh remains at an early stage of development. It needs to be strengthened and invigorated so it can fulfill its dual role of reducing poverty and promoting economic growth. This book presents a comprehensive analysis of the finance sector in Bangladesh and pinpoints areas of weakness in its subsectors.

Broad reforms to the sector and complementary parallel reforms are set out.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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