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Investment Climate in Bangladesh: Enhanced Role of the Capital Market

Dr. Prashanta K. Banerjee
Md. Mohiuddin Siddique

Economic Research Group

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Authors

Dr. Prashanta Kumer Banerjee[1]
Mohiuddin Siddique[2]

Mentors

Mohammad Musa *Ph.D*[3]
Farook Chowdhury[4]

ECONOMIC RESEARCH GROUP
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1 Senior Associate Professor, Bangladesh Institute of Bank Management (BIBM), Dhaka
2 Associate Professor, BIBM, Dhaka
3 Professor of Finance, School of Business, United International University
4 Program Manager, BMB Mott MacDonald, Dhaka.

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Executive Director
Economic Research Group
9/4 Lalmatia, Block D, Dhaka 1207
Email: info@ergonline.org
Telephone: 880-2-9135966 Fax: 880-2-9135966

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BIBM, Dhaka

Dr. Prashanta Kumer Banerjee
Mohiuddin Siddique

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1

INTRODUCTION

The investment climate is the state of the environment in which entrepreneurs operate. It is promoted by the government and its agencies to support entrepreneurs. Improvements in investment climate are beneficial to enterprises of all sizes enhancing their ability to access the market and make investment opportunities more lucrative. This, in turn, will create employment opportunities and foster economic growth. The investment climate includes factors (political, economic, financing and legal) that encourage and set conditions for the private sector to invest and create wealth.

One prerequisite of having a healthy investment climate in an economy is the availability of financing facility for the existing and potential borrowers. The two major sources of finance in any country are the banks and the capital market. However, the proportion of bank-based financing and stock market-based financing differs from country to country and it also changes within a country in different time periods. Historically, Bangladesh's private sector distinctly depends on banks for finance. Equity financing from capital markets through the issue of shares is lenient whereas debt financing through issuing corporate bonds is almost nonexistent. Bank financing was around 94 per cent of total finance while equity financing accounted for the remaining 6 per cent in 2007. This is expected in Bangladesh insofar as banks' loan typically precedes equity and bond financing as the important source of financing when a country's economy evolves from agrarian and becomes more industrial and services oriented. Barth et al. (2006) shows that high income countries own 91 per cent of the world debt securities, followed by middle income countries (7 per cent) and low income countries (around 2 per cent).

The financial turmoil that occurred in East Asia in mid-1997 taught the world that excessive reliance on banks as the primary vehicle through which savings are channelled to investment projects significantly exacerbates economic downturn when the banking sector suffers a crisis. The special characteristics of the banking sector of Bangladesh include development orientation instead of commercial orientation, vicious cycle of non-performing assets, lack of enforcement of regulatory and supervisory arrangement, absence of good infrastructure, and lack of efficient human resources. These inhibit banks' ability in prompt conversion of savings into productive investment. These limitations of the banking sector of Bangladesh increase the importance of having a sound and organized capital market for fulfilling the needs of financing business activities.

Well-functioning capital markets including equity and corporate debt markets are one of the most important factors needed to attract investors, both local and foreign. Greater emphasis on generating competitive and strong capital markets would ensure a sustainable flow of sufficient funds and efficient mechanisms for financing the private sector. An increasing amount of literature in this regard favors the development of the capital market for long-run growth. The capital market encourages specialization as well as acquisition and dissemination of information, thereby reducing the cost of mobilizing savings and facilitating investment (Greenwood and Smith, 1997).

The Bangladesh equity market was extremely depressed due to mass exodus of investors from the stock exchanges after the share market disaster of 1996. However, the market regained some of its momentum in the last couple of years. Introduction of automated trading through electronic registration and transfer of securities, simplification of rules and regulations, and guidelines on corporate governance on compliance basis helped to regain such momentum. Ten companies raised new equity of Tk. 5.61 billion in the primary market in 2008. The market capitalization increased by 96.21 per cent in Dhaka Stock Exchange and 94.76 per cent in Chittagong Stock Exchange in fiscal year 2008 as compared to the preceding fiscal year. Even then, high market investor-base, near-absence of solid legal protection for investors seem to act as barriers to mobilize adequate capital. So far, Bangladesh has been unable to entice any foreign portfolio investment.

Corporate debt market is virtually non-existent in Bangladesh, although bond markets are a prerequisite for a country to enter into a sustained phase of development driven by market -based capital allocation. At the same time, domestic bond markets markedly increase the resilience of a country's financial system by allowing corporate borrowers to choose from a broader range of financial instruments to fund their operations and insulate them against external shocks by reducing a country's dependence on foreign funds. Moreover, diversified sources of financing reduce firms' liquidity risk. Herring and Chatusripitak (2001) note that the absence of corporate bond markets may render an economy less efficient and significantly more vulnerable to financial crises. The ability of the US corporate bond market in tackling the banking crisis of 1980s is a constructive and shining example. The debt market helped the US corporate sector obtain required finance at the time of the banking sector's liquidity problems.

To say the least, the Bangladesh capital market till today is not broad or deep enough. Issuers do not use the full potential of the market for raising equity capital by issuing shares or for borrowing funds by issuing corporate bonds. Moreover, savers feel uncomfortable in investing in Bangladesh capital market instruments. Rather, they feel more comfortable in maintaining their savings with banks as Fixed Deposit Receipt (FDRs) and Savings Certificates. It seems that regulators fail to adequately address the problems faced by both the issuers and the investors. In this perspective, the following are needed in order to enable the capital market to play its due role in creating a friendly investment climate in Bangladesh: knowing the bank-based financing systems, examining the structure of organized capital market, sorting out and addressing the problems of issuers and investors. This study aims to address these issues with a view to creating a healthy investment climate in Bangladesh.

The following specific objectives have been pursued in this study:

- To map out the limitations of the bank-based financing system of Bangladesh.
- To examine the structure of the existing financial sector of Bangladesh emphasizing on an organized capital market.
- To analyze limitations and examine opportunities of the capital market of Bangladesh covering both equity and debt markets in creating a congenial investment climate.
- To provide a useful basis for building a sustainable capital market with a view to creating a healthy investment climate in Bangladesh.

2

LITERATURE REVIEW

Investment and economic growth are highly correlated. Growth might result from the quantitative or qualitative changes in factors of production or improvement in technology or a combination of both. The importance of the capital market lies in the fact that it is the primary source of external funds for corporate investment. A number of recent theoretical contributions suggest that stock markets promote long-term growth. Well-developed stock markets give due return to prudently-managed firms in the form of rising shareholders' wealth which may increase payment of managers. Thus it mitigates the principal-agent problem by aligning the interests of managers and owners, in which case managers strive to maximize firm value (Jensen and Murphy 1990).

The stock market contributes to economic development as it facilitates equity finance, spreads ownership among a large set of investors and thus mobilize the savings of the population, provides a mechanism for allocating capital to productive use and facilitates a link between the capital markets of a particular country and the markets of the industrial world (Ryrie, 1991). Demirguc-Kunt and Maksimovic (1998) find a positive relationship between stock market activity and a firm's ability to grow through the external acquisition of funds. Bencivenga et al. (1995) formulate models where more liquid stock market (less expensive to trade equities) encourages investors to fund long-duration projects because investors can easily sell their stakes in the project if they need their savings before the project matures. Thus, liquidity of the market boosts economic growth by facilitating investment in longer-run and higher- return yielding projects.

In contrast, Stiglitz (1993) argues that stock market liquidity does not enhance incentives for acquiring information about firms or improving corporate governance. Shleifer and Vishny (1986) and Bhide (1993) argue that more liquidity reduces the incentives of shareholders to undertake the costly task of monitoring managers resulting in weaker corporate governance and slowdown in effective resource allocation and decelerating productivity growth. Corbett and Jenkinson (1994), while discussing the contribution of stock market to corporate investment financing, suggest that it was negative in the United Kingdom and only marginally positive in the United States during the 1970s and the 1980s.

Similar studies considering only corporate bond markets are not available, perhaps, due to absence of data as history of corporate bonds is fairly new. Nakamura (2002) empirically studies the determinants of the amount of outstanding corporate bonds of Japanese manufacturing firms consisting of firms in the manufacturing industries that are listed in the first section of the Tokyo Stock Exchange and finds that the quantity of public debt issued by firms is positively correlated with the quantity of bank loans and the reputation of firms. Barth et al. (2001) suggest that the size of a nation's financial market (the sum of bank assets, equity market capitalization and value of outstanding bonds) is positively and significantly correlated with its level of economic development.

The remainder of this paper is organized as follows: Part II covers research methodology of the study. Part III briefly discusses the limitations of the bank-based financial system. Part IV examines the features of an organized capital market of Bangladesh. The sources of limitations and the areas of opportunities of the capital market on the basis of investors' and issuers' opinions covering equity and corporate debt market are reported in Part V. Part VI presents policy recommendations.

3

RESEARCH METHODOLOGY

Both primary and secondary data have been used in this study. First, primary data have been collected by administering an open-ended questionnaire to actual issuers and prospective issuers of equity shares. The sample was drawn randomly from the directory of members of the Metropolitan Chamber of Commerce and Industry with stratification. The sample includes the following category of firms: banks, financial institutions, engineering, food and allied, textile, pharmaceutical and chemical, ceramic, cement, and service providers. The Bangladesh Association of Publicly Listed Companies (BAPLC) also responded to the survey questionnaire. To ensure proper representation of the firms, stratification was done randomly and proportionately based on the industry classification of shares of the companies as per newspapers. However, in a few cases, units selected under stratified random sampling had to be dropped because of that particular firm's unwillingness to respond to the questionnaire. The willingness of the companies to respond to the questionnaire and their eligibility to participate in the capital market were considered before selecting the sample units. Finally, the total sample size comprised 25 respondents of which 12 are from both current issuers and prospective issuers and 1 is from BAPLC.

Primary data from the investors were collected with the help of brokerage houses and merchant banks. The sample size in this case is 50. Both open-ended and close-ended response questionnaires were administered. Individual investors represent a heterogeneous group comprising various professionals such as bankers, teachers, students, businessmen, IT programmers and those involved in other service sectors. Data from a handful of female investors have also been collected. The responses obtained from the issuers, the investors and BAPLC have then been placed before Securities and Exchange Commission (SEC) and Registrar of Joint Stock Companies and Firms (RJSCF) for their reactions.

Secondary data sources include World Development Indicators, International Financial Statistics, Asian Development Outlook, Annual Reports of Bangladesh Bank and BAPLC, including various reports and publications of SEC, Chittagong Stock Exchange (CSE) and Dhaka Stock Exchange (DSE). The researchers have tried to use data sets spanning five years with some exceptions depending on availability.

This study is mostly qualitative in nature. After data collection, necessary screening has been performed before tabulation and graphical presentation. The concerns expressed by the issuers and the investors, and the reactions of the regulators have been analyzed. Finally, based on the findings and analyses, policy recommendations have been made. Statistical, financial and accounting tools and concepts have been applied in this study where appropriate.

4

LIMITATIONS OF THE BANK BASED FINANCIAL SYSTEM OF BANGLADESH

The banking sector in Bangladesh consists of four categories of banks in terms of their ownership. These are: State Owned Commercial Banks (SCBs), Development Finance Institutions (DFIs), Private Commercial Banks (PCBs) and Foreign Commercial Banks (FCBs). Among these groups, PCBs hold more than 50% of both total deposits and assets in the banking industry followed by SCBs with a deposit share of 32.6% and asset share of 33.1% in 2007 (Bangladesh Bank (BB) Annual Report 2007/08). However, the number of bank branches of SCBs is nearly double than those of PCBs and the geographical coverage of SCBs is also far more extended than the PCBs. There are some big state owned DFIs, some of which have been developed to finance projects in the agriculture sector and the others to meet long term need of the industrial sector. Since the 1990s, the banking sector has gone through a long reform process with the ultimate objective of making it more sound, competitive and resilient to adverse economic conditions. Gradual improvement in the banking sector has been observed but the potential of this sector is still untapped. Some major limitations of the banking sector are mentioned below:

- Banks by nature are not well-suited for long term lending. According to a report published by the World Bank in 2008, 69 per cent of lending has a maturity period of less than 3 years in metropolitan areas. The average term for bank loans in non-metropolitan areas was 17 months. After independence, state-owned Bangladesh Shilpa Bank and Bangladesh Shilpa Rin Sangstha were entrusted with the responsibility of providing industrial term loan to meet the long term financing needs of the economy. But, the attempt was not very successful as a significant percentage of credit given through those institutions became non-performing.

- A major problem in our banking sector is the accumulation of huge amounts of non-performing loan. The NPL ratio stood at 13.2% as at end-December 2007 (BB Annual Report, 2007-08) which is still very high although there has been a downward trend of NPLs for the last couple of years. SCBs and DFIs suffer most from NPL problems as about 30% of loans disbursed by these categories of banks are non-performing. PCBs are doing better in this regard as 5% of their loan is non-performing. In developed countries, the tolerable range of NPL is up to 3%. The performance of the banking sector in neighboring countries in this regard is also much better compared to Bangladesh. NPL ratios in India, Sri Lanka and Pakistan are 1.9%, 5.6% and 7.7%, respectively.[1] The NPL problem has several damaging effects starting with sub-optimal utilization of resources. On the supply side, it is limiting the recycling of funds and forcing certain banks to follow a very conservative policy of approving loan applications which ultimately makes it difficult for new firms to get access to finance.

- Ideally, the interest rate should be correlated to the risk level posed by the borrower i.e. the more risky a borrower is, the higher interest rate he should pay and vice versa. The difference between the interest rate would serve as a 'risk premium'. But, we do not observe such variation in the interest rate among the borrowers classified in the same sector. Banks' risk analysis of borrowers is mainly reflected in the decision of accepting or rejecting the loan proposal; not so in differentiating the interest rate. The country also lacks an updated, adequate and reliable database of the business enterprises. Existing of such data base can be helpful for banks to classify their borrowers under different risk categories. However, we might expect an increase in the availability of company risk profiles with institutional development of the few number of credit rating agencies that are operating in the country.

- In many cases, banks place an undue weight on collateral security rather than on forecasted cash flow in approving/rejecting a loan application which makes it difficult for some potential entrepreneurs to meet the banks' requirement (The World Bank Report, 2008). As a result the idea of 'entrepreneurship development' by banks is not practiced or cultured in our banking system.

- Bank management must ensure the same set of standards both for the insider loan and loans granted to the others. The issue of loans given

1 Data of NPL ratio in India and Pakistan are as of June, 2008 whereas the NPL ratio of Sri Lanka is measured in June, 2007.

to insider parties emerged as a matter of concern in the mid ’80s after the operation of private commercial banks in Bangladesh has begun. Although Bangladesh Bank has adopted various measures for ensuring prudent management of insider-loans, our banking sector is still burdened with a high amount of defaulted loans granted to insiders.

- Although there is a wide area network of branches of state owned commercial banks in Bangladesh, lending is concentrated in urban areas. Thus, inequitable transfer of funds from the rural areas to the urban areas is observed. Moreover, private commercial banks, in operation since 1990, have very few rural activities. This pattern of urban-based credit portfolio makes the target of equitable development unachievable. Also there is a disparity between the rural areas and the urban areas in the quality of banking services offered. In recent years, a number of modern information and communication technology based banking products have been made available mainly in the urban areas.

- One of the major problems in the financial system of Bangladesh is the absence of an exit policy. In one way or another, banks are allowed to continue their operation even in the face of severe problems. A number of banks in our country, in the past, continued their operation without meeting the minimum capital requirement and with a substantial amount of defaulted loans. It seems that depositors were also not made aware of varying levels of risk with different banks and, as a result, are unable to take their deposit decisions based on the riskiness of the bank. This is an example of a moral hazard problem where weak banks are not pressurized by the stakeholders, especially by the depositors although they have representation in board of directors of banks, to make their operation sound and efficient. This problem implies that Bangladesh’s banking sector does not have adequate market discipline.

- One of the major objectives of the regulatory body is to ensure financial stability which, in turn, depends on banks’ compliance with existing prudential measures. A number of instances of regulatory failure in Bangladesh’s banking sector have been observed such as violations of the provisions relating to the member of board of directors, amount of shareholding by the directors, etc. The case of the defunct ‘Oriental Bank’ in the recent past is evident of such costly forbearance policy. Inadequate regulatory compliance and lack of market discipline in the banking sector might be due to the lack of competence on the part of the regulatory body and/or to the lack of autonomy of the central bank. Like most other developing countries, there is a sharp difference between legal independence and the de facto independence of the central bank in our country. Thus, it becomes difficult for the central bank to take punitive actions whilst being a part within the overall legal environment of the country.

5

FETURES OF AN ORGANIZED CAPITAL MARKET OF BANGLADESH

Sources of Finance

Bangladesh is dominated by a bank-based financing system. The amount of industrial term-loan disbursements by banks and financial institutions stood at Tk. 201 billion in 2008. This amount is roughly 36 times higher than Tk. 5.6 billion, which is the amount raised by new share issues in 2008. The disbursed loan amounts as percentages of Gross Domestic Product (GDP) range from 1.32 to 3.72 compared to amounts raised through Initial Public Offering (IPOs) percentages of GDP, which vary from 0.01 to 0.10. This shows overdependence on bank financing system in Bangladesh.

Table 1: Sources of Finance: Disbursed Amounts of Term-Loans and Amounts through IPOs

BDT in Million

Year	Disbursement of Term-Loans		IPOs	
	Amount	Percentage of GDP*	Amount	Percentage of GDP
2003	39,700	1.32	1351.17	0.04
2004	66,800	2.01	473.88	0.01
2005	87,000	2.35	1265.70	0.03
2006	96,500	2.32	1433.95	0.03
2007	124,000	2.65	4638.13	0.10
2008	201,500	3.72	5613.00	0.10

Source: BBS Annual Reports and BAPLC Annual Reports.
Note:* GDP has been contemplated at current price.

The outstanding amount of term-loan of Tk. 400 billion in 2008 is lower than the total amount of market capitalization of Tk. 964 billion showing less dependence on bank finance. However, market capitalization of manufacturing & service sector amounting to Tk. 289 billion is lower than the outstanding amount of term-loan financing. In addition, outstanding term-loan as percentage of GDP is 6.26 per cent. This is also higher than the percentage of market capitalization of manufacturing and service sectors to GDP, 4.52 per cent in 2007-08. These indicate overwhelming preference for bank-based industrial financing in Bangladesh.

Table 2: Sources of Finance: Outstanding Term-Loans, Equity Market Capitalization and Corporate Bonds

BDT in Million

Year	Outstanding Term-Loan	% of GDP	Market Capitalization					
			Total Capitalization	% of GDP	Manufacturing & Services	% of GDP	Corporate Bond & Debenture	% of GDP
2004-05	226,300	6.10	427,655	11.54	91,853	2.48	576	.016
2005-06	273,800	6.59	421,641	10.14	114,307	2.75	576	.014
2006-07	339,200	7.18	890,183	18.84	222,008	4.70	576	.012
2007-08	400,900	6.26	964,800	21.35	289,300	4.52	3503	.065

Sources: Economic Trends, Bangladesh Bank, BB Annual Reports, SEC Annual Reports and DSE Monthly Reviews.

Stock Market Size

Market capitalization shows the overall size of the capital market. It reflects the level of investment in securities in the secondary market. Given the supply of stocks, price surges will increase market capitalization and vice versa. Market capitalization was at its peak in 2008 climbing to Tk. 1043 billion in 2008 from only Tk. 224 billion in 2004. The role of the financial sector in market capitalization is evident in Table-3. The financial sector including banks, insurance companies and investments hold over 43.44% of market capitalization in 2008 whereas the manufacturing sector together with service and miscellaneous sectors capture only about 34.42%. In terms of compound annual growth rate (CAGR), the market capitalization of the manufacturing sector also shows a slow growth rate (19.80%) compared to the financial sector's growth rate of 37.36%. The share of market capitalization of the manufacturing sector dwindled from 43.37% in 2004 to 19.18% in 2007. These indicate subdued preference of the manufacturing sector to raise funds from the organized capital market.

Table 3: Sector-wise Market Capitalization of DSE

BDT in Million

Year	Market Capitalization						
	Financial Sector			Other than Financial Sector			Total
	Banks	Insurance	Investment	Manufact-uring	Service & Miscellaneous	Bond*	
2004	104816 (46.71%)	9285 (4.14%)	2070 (0.92%)	97336 (43.37%)	10898 (4.86%)	N.A	224,405
2005	118395 (53.59%)	8507 (3.85%)	2154 (0.98%)	77373 (35.02%)	14480 (6.55%)	N.A	220,909
2006	150861 (54.57%)	8939 (3.23%)	2322 (0.84%)	80597 (29.17%)	33710 (12.20%)	N.A	276,429
2007	372294 (49.42%)	21709 (2.88%)	10800 (1.43%)	140163 (18.62%)	81845 (10.86%)	126,568 (16.79%)	753,379
2008	373286 (35.76%)	45194 (4.33%)	35010 (3.35%)	200207 (19.18%)	159089 (15.24%)	246616** (23.63%)	1043799
CAGR	37.36%	48.55%	102.78%	19.80%	95.47%		46.85%

* Bond includes Govt. bond, corporate and debenture. ** As on November 30, 2008

Note: Figures in parentheses represent percentages of sector-wise market capitalization to total market capitalization.

Sources: BAPLC Annual Reports and DSE Monthly reviews.

Capacity of DSE

DSE's capacity of dealing with trade volume is limited. Earlier, DSE was able to handle 1 lakh transactions per day while now, after the first phase of its expansion program, it can handle 1.5 lakh transactions per day. It is expected that DSE will be able to increase this capacity to 2.5 lakh transactions per day after completion of the second phase of expansion program. Still, this capacity is not enough. Recently, when Grameenphone proposed to float around 148 crores worth of shares at Tk. 1 per share through IPO, DSE had recommended SEC to fix the face value at Tk. 10 instead of Tk. 1 because at Tk.1, at the time the shares make debut on the stock market, the number of transactions may exceed 2.5 lakhs a day.

Category of Companies

The dearth of good shares in the capital market of Bangladesh is observable from Table 4. The number of shares under A-category in DSE having good fundamentals is only 171 out of a total of 293 in 2008. Of the remaining shares, Z-group represents 94 shares, followed by B, and N categories, respectively. This indicates a scarcity of good shares in the face of a huge number of investors. Moreover, numbers of shares under different categories move very slowly. The share of A-category moved from 47.37 per cent to 58.36 per cent during 2005-2008 while share of Z-category decreased from 40.08 per cent to 32.08 during the same period representing a slow addition to A-category share and lenient graduation from Z to other categories of share.

Table 4: Category of Companies

Year	Name of Category					
	A	B	Z	G	N	Total
2005	117 (47.37%)	30 (12.15%)	99 (40.08%)	1 (0.40%)	0 (0.00%)	247
2006	124 (48.63%)	32 (12.55%)	93 (36.47%)	1 (0.39%)	5 (1.96%)	255
2007	133 (49.81%)	27 (10.11%)	96 (35.96%)	1 (0.37%)	10 (3.75%)	267
2008	171 (58.36 %)	19 (6.48 %)	94 (32.08 %)	0 -	9 (3.07%)	293

Source: BAPLC Annual Reports

Volatility

The volatility in share markets has become a matter of concern in recent years for investors, regulators and brokerage firms. This concern centers on the perception that high volatility can lead to a general erosion of investors' confidence and flow of capital away from the share market. Levine and Zervous (1998, p.550) in their seminal paper find that stock return volatility is not linked with future growth and productivity improvements. During the past four years, significant fluctuations have been observed persistently in all indexes used in DSE and all share price indexes in CSE. The coefficients of variation of all share indexes climbed up to 25.57% in 2007 from 6.81% in 2005 which dropped again to 7.13% in 2008. Similar variability has been observed in the case of the general index and top 20 indexes of DSE. Volatility of CSE in terms of all share price indexes has been less compared to DSE.

Table 5: Volatility of Index: Measured by Coefficient of Variation

Year	DSE Index			CSE Index
	All Shares	General	Top 20	All Shares
2005	6.81	7.18	9.53	5.18
2006	9.31	7.04	21.88	11.66
2007	25.57	20.12	19.68	10.13
2008	7.13	6.43	5.38	6.95

Sources: BAPLC Annual Reports and SEC Annual Reports.

Dividend and Capital Gain

The amount available from dividend (cash + stock) and capital gain depicts shareholders preference either for dividend or capital gain. Table 6 shows that 7 of 11 selected sample companies offered shareholders more capital gain than dividend, remaining four gave more dividend than capital gain in 2008. One may conclude from this statistics that shareholders may be more interested for reaping capital gain through frequent buying and selling of shares instead of enjoying yearly dividend by undertaking costly task of monitoring fundamentals of the company. This may cause more volatility in the market.

Table 6: Dividend and Capital Gain of Per Share of Selected Sample Companies in 2008

Name of Company	Par Value	Dividend			Price		Capital Gain	Difference Between Capital Gain and Dividend
		Cash	Stock	Total	Jan 1, 2008	June 30,2008		
AB Bank Ltd	100	0.00	2648.50	2648.50	2641.75	1324.25	-1317.50	-3966.00
Lanka Bangla Finance	10	1.50	22.13	23.63	98.90	221.30	122.40	98.77
IDLC	100	15.00	528.35	543.35	1505.50	2641.75	1136.25	592.90
Uttara Finance	100	30.00	0.00	30.00	687.75	797.75	110.00	80.00
Aziz Pipe	100	0.00	0.00	0.00	222.25	200.75	-21.50	-21.50
Rangpur Foundry	10	1.60	0.00	1.60	29.40	57.90	28.50	26.90
Reckit and Benkeizer	10	22.00	0.00	22.00	370.40	519.40	149.00	127.00
Monno Fabrics	100	5.00	0.00	5.00	65.50	88.75	23.25	18.25
Reneta	100	50.00	1480.30	1530.30	7793.75	7401.50	-392.25	-1922.55
Prime Textile Ltd.	100	10.00	0.00	10.00	87.50	144.25	56.75	46.75
Ashraf Textiles Ltd.	10	0.00	0.00	0.00	10.30	9.40	-0.90	-0.90

Notes: Calculation procedures of the following are: Cash Dividend = Par Value of the Share × Cash Dividend Rate; Stock Dividend = Market Value of the Share × Stock Dividend Rate and Capital Gain = Price of June 30, 2008 – Price of Jan 01, 2008.
Source: The Daily Star

Liquidity

A large stock market does not necessarily imply a liquid market. A large but inactive market will have large capitalization but small turnover. Market liquidity as measured by turnover and value traded ratio2, which, of Dhaka Stock Exchange and Chittagong Stock Exchange, shows substantial variations during the period of 2003-2008. DSE's turnover ratio ranged between 17.40 per cent and 56.31 per cent while CSE's turnover ratio ranged between 5.81 per cent and 10.21 per cent. The

2 Levine and Zervous (1998) estimates liquidity of stock market by using turnover and value traded ratios. Turnover ratio measures trading relative to the size of the stock market and value traded ratio captures trading relative to the size of the economy.

value traded ratio also indicates high liquidity variation of the secondary market of Bangladesh. This is supported by the Coefficients of Variation of both ratios of DSE and CSE, which are exorbitantly high. In addition, Bangladeshi stock exchanges seem less liquid as compared to India and Pakistan. The average turnover ratio and value traded ratio of Bangladesh are less than those of India and Pakistan. But the real question is whether a liquid market is good or bad. A more liquid market encourages investors to invest in long-duration projects as investors can easily sell their stakes if they need money. This, in turn, boosts capital market. However, since more liquidity reduces the incentives of shareholders to undertake costly task of monitoring company performance, weaker corporate governance slows productivity growth.

Table 7: Market Liquidity: Turnover Ratio and Value Traded Ratio

Year	Turnover Ratio				Value Traded Ratio			
	DSE	CSE	India	Pakistan	DSE	CSE	India	Pakistan
2003-04	17.4	6.7	14.1	40.1	0.74	0.25	47.4	80.9
2004-05	29.02	8.27	115.5	322.5	1.76	0.45	54.8	76.9
2005-06	20.41	5.81	93.6	375.7	1.11	0.27	55	127.3
2006-07	33.49	8.58	96.4	251.4	3.52	0.73	N.A	N.A
2007-08	56.31	10.21	N.A	N.A	10.03	0.46	N.A	N.A
Mean	31.33	7.91	79.90	247.43	3.43	0.43	52.40	95.03
S. Deviation	15.39	1.71	44.93	147.30	3.84	0.19	4.33	28.02
Coefficient of Variation (CV)	49.13	21.65	56.24	59.53	111.88	44.72	8.27	29.48

Sources: SEC Annual Reports and World Development Indicators.

Difference between Offer Price and Initial Trading Price

Issuers offer their issues at a price fixed by them in tune with the guidelines of SEC of Bangladesh. Fixing offer price is crucial both for the issuers and investors. If the promoters float their shares with hefty premium, investors have to suffer a great loss of funds. In contrast, the company does not receive proper value if new issues are underpriced. Table 8 shows that the offer prices of all shares floated in 2008 was much less than average trading price of the first three days. Average trading price is more than offer price by two to eight times. The Mann-Whitney test also supports these findings, which means that the issuer is not receiving proper value of shares.

Table 8: Pattern of Deviation between Par Value and Market Value of Primary Shares

Name of the Company	**Average Trading Price***	**Offer Price**	**Difference**
Fidelity Assets	306.67	100	206.67
Continental Insurance Ltd.	159.92	100	59.92
Delta-BRAC Housing (DBH)	1528.08	210	1318.08
Golden Son Ltd.	22.83	10	12.83
ICB AMCL 2nd NRB Mutual Fund	181.00	100	81.00
Grameen One: Scheme Two	41.67	10	31.67
First Security Bank Ltd.	191.42	100	91.42
Summit Alliance Port Ltd.	901.67	100	801.67
Takaful Islami Insurance Ltd.	319.58	100	219.58
Mann- Whitney U-Test			
Calculated Value	− 2.076	Alternative hypothesis is accepted meaning there is difference between average trading price and offer price	
Tabular value at 5% level of significance	1.96		

ICB- Investment Corporation of Bangladesh
* Averages have been calculated on the basis of first three trading days' closing prices.
Sources: www. dsebd.org. and The Financial Express

Issue Cost of IPO

IPO costs are considered to be a barrier to public offerings. It still includes several costs, namely, manager to the issue fee, SEC fee, Stock Exchange fee, underwriting fee, Central Depository Bangladesh Limited (CDBL) fee, bankers to the issue commission and credit rating fees. The cost is not worth bearing in the case of small IPOs. Issue costs reach around 5 per cent of issue amount in case of raising approximately Tk. 20 crores. However, the amount comes down in average in the case of big issues, since the costs do not increase in the same proportion as the increase in the amount raised through IPO. For example, issue costs amounting to Tk. 2.2 crores of First Security Bank though appear high as a whole; it is only 1.99 per cent of the IPO amount.

Table 9: Proposed Expenses of Some Selected Companies for Raising Funds through Initial Public Offering (IPO) in 2008

Amount in Taka

Name of the Companies	Total IPO Expenses	Amount Raised from IPO	% of IPO Expenses of Amount Raised
First Security Bank Ltd	22,855,000	1,150,000,000	1.99
Bay Leasing and Investment Ltd.	5,687,750	250,000,000	2.23
BSRM Steels Ltd.	12,192,500	200,000,000	6.10
Delta Brac Housing Finance Corporations Ltd	5,580,000	105,000,000	5.31
Summit Alliance Port Ltd.	6,672,000	100,000,000	6.67
Northern General Insurance CO. Ltd.	4,959,000	90,000,000	5.51
Republic Insurance Ltd.	4,890,000	90.000,000	5.43
Standard Insurance Ltd.	4,790,000	90,000,000	5.32
Maksons Spinning Mills Ltd	3,917,500	80,000,000	4.90

Source: Calculated from figures on prospectuses of respective companies

Price Earnings (P/E) Ratio

A high P/E ratio suggests investors are expecting a higher earnings growth in the future compared to companies with a lower P/E ratio. The P/E ratio of DSE rose steeply from 13.04 to 23.10 between 2006 and 2007, and CSE has depicted a similar trend. Comparing with P/E ratios of regional exchanges, only Bombay SE has higher P/E ratio over DSE and CSE. Colombo and Thai P/E ratios are far below DSE and CSE P/E ratios. However, P/E ratio does not tell us a whole story by itself. P/E ratio shows how much investor is willing to pay per Tk. of earnings. However, investing in Bangladesh, perhaps, depends more on speculative analysis. These result in overpricing of shares. So willingness of the investors to pay per Tk. earnings is not reflected in P/E ratio. Moreover, investors are not getting good returns.

Table 10: P/E Ratio and EPS of DSE and CSE

Exchanges	2007	2006
DSE	23.10	13.04
CSE	22.70	13.15
Bombay SE	29.10	19.20
Colombo SE	11.60	14.00
Thailand SE	12.60	8.10

Sources: www.dsebd.org, www.econstats.com

Institutional Investment

Institutional Investment is negligible in Bangladesh. Institutional investment as percentage of total market capitalization ranges between 4.53 per cent and 4.88 per cent during 2005-2008. Institutional investment brings long-term commitment and greater focus on the fundamentals and, hence, stability in the market. Furthermore, the presence of institutional investor is also expected to ensure better valuation levels due to their special analytical skills. Bangladesh capital market missed this source of efficiency gains as institutional investment is very small in both absolute and percentage terms.

Table 11: Institutional Investments ((ICB and Scheduled Banks)

BDT in Billion

FY	ICB and Scheduled Banks	Percentage to Market Capitalization
2005	20.00	4.68
2006	20.56	4.88
2007	33.45	3.76
2008	43.71	4.53

Source: Annual Reports of Bangladesh Bank

Investments by Non-Resident Bangladeshis (NRBs)

Investment by NRBs does not reveal a strong presence in the Bangladesh capital market. Furthermore, it shows year-to-year substantial variations. In 2006 and 2007, net investment by NRBs recorded a discernible positive amount (Table 12). The positive investment atmosphere in local market prevalent throughout 2007 is considered to be one of the main reasons behind this investment. However, the net investment reached negative territory amounting to Tk. 2170 million in 2008. Someone may conclude that, in the wake of global financial meltdown, an existence of selling pressure instead of fresh investment was evoked. This slowed down the net portfolio growth, although very insignificant market integration is presumed between Bangladesh and some selected countries.

Table 12: Yearly Portfolio Investments by NRBs

BDT in Million

FY	Investment in Securities	Outflow of Sold Amount	Net Investment by NRB
2004	298.90	56.20	242.70
2005	53.10	315.50	-262.40
2006	2420.60	185.10	2235.50
2007	8359.20	1482.30	6876.90
2008*	5500	7670	-2170.00

* As per calendar year, FY =Financial Year

Sources: SEC Annual Reports and Bangladesh Bank Annual reports.

6

SURVEY RESULTS

Equity Market: Investors' Opinions

Problems Faced in the Primary Market

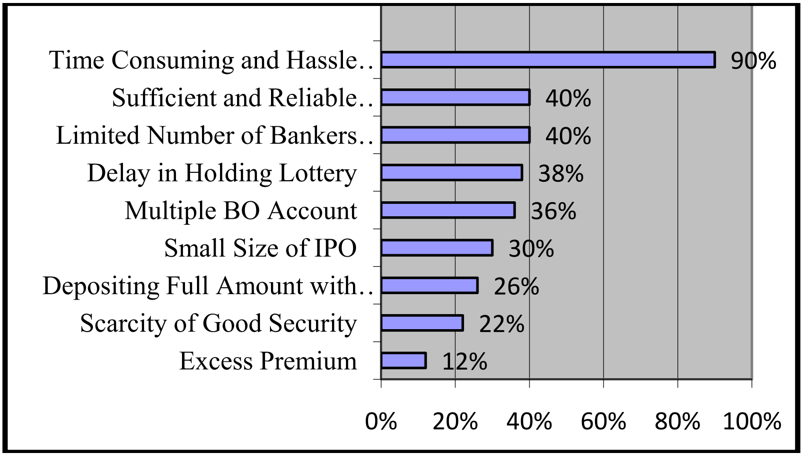
The volume of public offerings in FY 2008 was oversubscribed by more than four times (BB Annual Report, 2008). It indicates high demand for new securities in the primary market. Despite this enormous response to initial public offerings, investors feel uncomfortable for several reasons. They are as follows:

A time consuming process and hassle in collecting refund amount is a major problem to the investors in the primary market. 90 per cent of the investors consider it as the main problem in the case of IPOs. Investors are skeptical regarding the time and in some cases low chance of refund amount. It is alleged that issuers in collaboration with banks use the opportunity to hold the money of unsuccessful investors for several months in order to get undue benefits through reinvestment. Sometimes investors face problems in getting refunds because their names are not properly written in the issuers' book. Moreover, investors face delays in receiving refunds because of accusations against them for maintaining multiple Beneficiary Owners (BO) accounts or making several applications in the same name.

Forty per cent of investors claimed that issuers do not provide sufficient and/or reliable information in their prospectus. As issuers are not accountable to regulators and SEC does not check the items of the prospectus meticulously, they are ambivalent in this regard.

Investors in IPOs are uncomfortable in collecting and depositing application forms because of a limited number of bankers to the **issues**. 40 per cent of investors opined that a limited number of bankers to the issues and time-consuming deposit making process constitute a hurdle in the case of IPOs. Thus, increasing the number of bankers to the issues including bank branches and provision of accepting online applications would minimize this problem.

Figure 1: Problems Faced by the Investors in the Primary Market



Source: Survey Results

Delay in holding draw is another barrier to unsuccessful investors for getting back their money in time. It is understandable that issuers need some time for lottery and allotment process, but 6 (six) weeks from the closure of the subscription date is considered too long for this process according to thirty eight per cent of the respondents. They opined that lottery should be conducted within a maximum of 3 (three) weeks and the whole process should be completed within one month.

Genuine investors face harassments because of **multiple BO accounts** held by unscrupulous investors. Thirty six per cent respondents concurred on this view. They linked more problems with BO accounts opened at the initial stage of this provision, as fake and multiple BO accounts are opened by some investors. Meticulous examination of required information in the BO accounts form, namely, passport/voter ID number, driver license and bank statement can be expected to discourage investors to open fictitious multiple BO accounts.

Depositing whole amount with application is a deterring factor to many investors. Around 26 per cent respondents mentioned that it is burdensome. They suggested that 20-25 per cent money should be paid during the application time and the remaining amount payable within 10 days after allotment, easing the pressure on investors.

Small size of IPOs compared to total capital requirement of the issuers, scarcity of good security and excess premium are also considered as problems in the primary market. 30 per cent, 22 per cent and 12 per cent of the respondents respectively believed these pose barriers to the primary equity market in Bangladesh.

To examine the interdependence among variables, χ^2 test has been implemented. The calculated value of χ^2 at 5% level of significance is larger than its critical value. This shows statistical interdependence among the variables meaning that the variables under consideration influence one another. However, this does not identify the cause and effect relationship among the variables under specified in multiple regression form.

Problems Faced in the Secondary Market

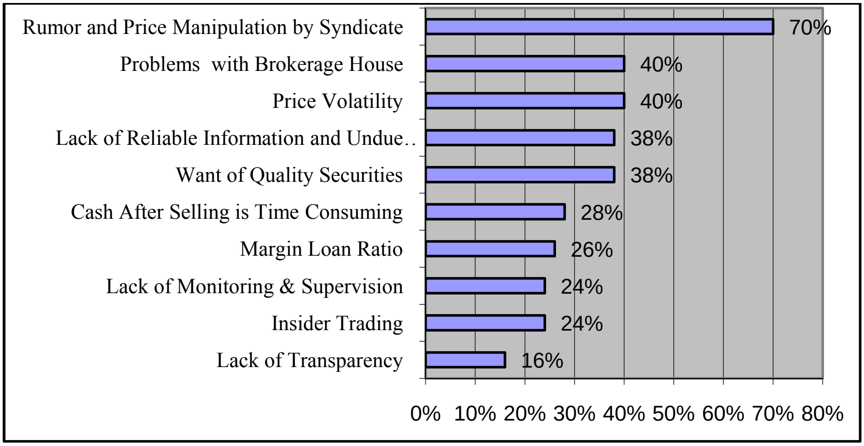
The secondary market experiences unreasonable ups and downs, despite neither any change in our economy nor any earning forecasts downshift by any leading companies. A closer look at the problems faced by the investors would be helpful.

Investors make decisions based on **rumors** in most of the cases instead of analyzing company specific fundamentals. This was conjectured by 70 per cent of the respondents. Small and new investors are pronouncedly affected by rumors. More than 1 lakh new investors entered the equity market in the last two years and most of them depended on rumors as they have no clear access to market information and are not equipped with sophisticated investment tools or techniques. The SEC, merchant bankers and brokerage houses can organize regular awareness program for investors to help them make rational investment decisions and to warn them against rumors to mitigate possible stock market over-reactions/under-reactions.

Inadequate brokerage houses, poor service of brokerage houses and high brokerage cost are discouraging factors to the secondary market investors. Forty per cent respondents consider these as hurdles in the secondary market. Brokerage houses are confined to major urban areas and are located in sporadic geographical locations with poor infrastructure. Aspirant investors in many parts of the country are therefore not getting the needed service of brokerage houses. Moreover, the quality of brokerage houses is supposed to be assessed by research produced by the independent research departments, which is nearly nonexistent in Bangladesh. Brokerage fees range from 0.5 per cent to 1.0 per cent in Bangladesh. It varies from one brokerage house to another and even from one investor to another as well. However, this cost is almost at par with other Asian countries. Brokerage fee in Pakistan, Thailand and China is 1%, 0.64% and 0.56 %, respectively.

High volatility, already shown earlier, is a matter of serious concern to 40 per cent of the respondents. Margin regulations, circuit breakers, price stabilization funds and securities transaction taxes are used to tackle short-term price volatility in different countries. Unfortunately, very little empirical work has been done in Bangladesh on these issues about their practicalities and implications.

Figure 2: Problems Faced by the Investors in the Secondary Market



Source: Survey Results

Dearth of quality securities is again considered as an obstacle in the secondary market by 38 per cent of the respondents. This is supported by the number of shares under A-category. In DSE, only 171 out of total enlisted companies of 293 in 2008 have good fundamentals. Similarly, lack of reliable information and undue interruption by SEC are also causes of concern in the secondary market.

Cashing out after selling shares is time consuming and 28 per cent of the respondents are worried about the length of time in the settlement process. It requires T+3 days for A, B, G and N category and T+ 7 days for Z category shares in Bangladesh. Respondents view that it should be brought down.

Off and on changes in the margin loan ratio destabilize the market. Twenty six per cent of the respondents opined this. SEC uses margin loan ratio to control the market and re-fixes it from time to time. Furthermore, merchant banking divisions of Non Banking Financial Institutions (NBFIs) cannot provide more amounts to the investors as they are not allowed to hold exposure (loan to investors, own investments, and commitment for underwriting) more than five times of their paid-up capital. Respondents also added that merchant banks have sometimes compelled their clients to sell off shares to repay loans. These reduce their investing capacity. SEC should let merchant banks to lend to investors within their own parameters. As loans are collateralized by securities and mark to market system is introduced, banks are capable of lending on the basis of their own norms. However, if the stock price declines to the point where equity drops by a prescribed percentage, the investors may be asked to provide more money to replenish the collateralized value.

Insider trading transactions on the basis of undisclosed price sensitive information to public manipulates the market. This is viewed negatively by around 24 per cent of the respondents. For example, the share price of Popular Life Insurance peaked from Tk. 911 to Tk. 5000 between June 2007 and March 2008. SEC found insider trading behind this excessive price movement and punished the culprits. However, this is not a common practice. Investors expect that stock market watchdogs should take exemplary actions against insider traders and persons responsible for leaking price sensitive information.

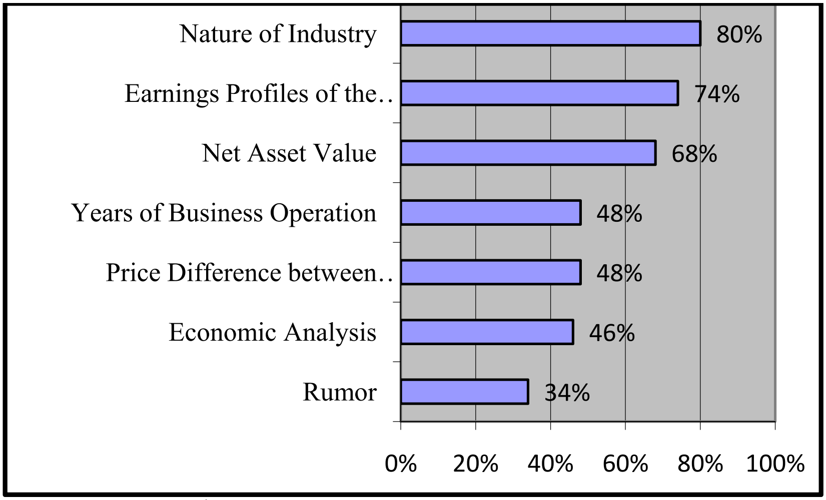
An important role of stock market regulators is to ensure that there is transparency to create a level playing field for small, large and institutional investors. 16 per cent of the respondents are not satisfied with the current status of monitoring, supervision and transparency of the secondary market. They opined that companies' ongoing reporting of financial results is not honest and a so-called syndicate in price manipulation does exist.

The calculated value of χ^2 at 5% level of significance is larger than its critical value. This shows statistical interdependence among the variables.

Factors considered in Buying Shares from the Primary Market

The enormous number of investors' responding to initial public offerings has largely been due to low initial public offerings by the companies compared to the excess demand for primary issues. It is also clear from the responses that they look into certain factors before buying IPO shares, the most important of which are presented below.

Figure 3: Factors Considered in Buying Shares from the Primary Market



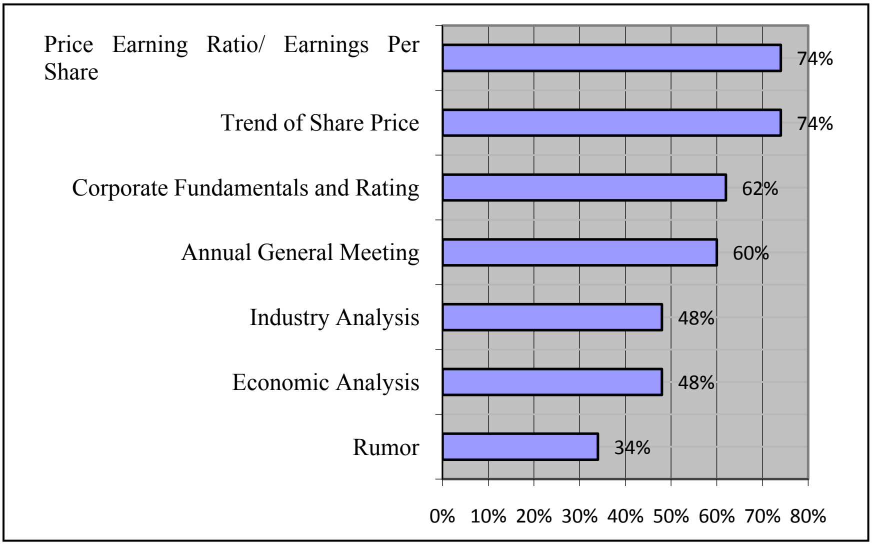
Source: Survey Results

Investors assign maximum weight to the nature of the industry. Eighty per cent of the respondents opined that pharmaceuticals and fuel and power industries are on their priority choice list. These are followed by banking, cement and textiles sectors. Earnings profiles of the companies are mentioned by 74 per cent of the respondents. Investors generally analyze the earnings profile of a company using Earnings Per Share (EPS), P/E Ratio, earnings growth, dividend per share, dividend yield, etc. Net Asset Value (NAV) per unit, and total assets & liabilities of the companies are other factors which are considered. 68 per cent of the respondents recorded the above. Years in business operation are considered as well, which is an indicator of resilience of a company during rough as well as calm business weather. 48 per cent of the respondents offered this view. Anticipated price difference between IPO and secondary market is yet another important determinant for participating in IPOs. If price difference is perceived to be more for a share, investors flock to it. This is a view held by 48 per cent of the respondents. These aforementioned factors are followed by economic analysis (46%) and rumors in the market (34%). The calculated value of χ^2 at 5% level of significance is larger than its critical value. This shows statistical interdependence among the variables.

Factors considered in Trading Shares in the Secondary Market

Price/earnings ratio and earnings per share are considered by 74 per cent of the respondents when considering whether to buy shares from the secondary market or not. Usually, shares with good fundamentals have high P/E ratios. It rewards a company for its good prospects, good governance, openness and transparency. However, small investors sometimes shy away from buying these shares, as the costs are more than concomitant perceived benefits.

Figure 4: Factors Considered in Buying Shares from the Secondary Market



Source: Survey Results

Trend of traded share price is a major consideration of the investors. Seventy four per cent of the respondents hold this view. However, this trend is considered mostly by individual investors. They believe that the trend of share price is upward in the first half (January-June) of the year and the second half of the year turns out to be in a sliding mode. This indicates a seasonal variation in the secondary market. Consequently, the first half of the year is considered more appropriate for selling shares whereas the second half for buying shares. Trend of share price in 2008 supports this perception of the investors. Regular and institutional investors do not assign large weight to this trend as their goal is to reap benefits from regular trading.

Sixty two per cent of the respondents mentioned that their trading is always driven by corporate fundamentals and ratings. However, they confessed that lack of transparency and accountability sometimes undermines their confidence. As mentioned earlier, their concern about effective instruments of the market watchdogs is very important. Regarding this, US – Sarbanes – Oxley Act of 2002 known as 'Sox' can be a good lesson for Bangladesh. This forces company Chief Executive Officers (CEOs) and auditors to sign on personally subjecting themselves to substantial penalties for false reporting or manipulation of accounts.

Annual General Meeting (AGM) is a strong determinant for market trading. 60 per cent of the respondents believe in it. Common assumptions are that share prices record spikes before and around the book closure date, since logical sequences of AGM include allocation of right share, declaration of cash and stock dividend as well as inclusion of shares in category-A.

The demand for an individual stock also varies in tandem with their expectations for earnings prospect of the respective industry. 48 per cent respondents considered this as another factor.

Among others, economic outlook as reflected in the trend of macroeconomic variables, rate of interest and money supply are also factored in by investors before their decision making. Around 48 per cent of the respondents share this view.

Finally, rumors in the market change the decision of the investors. 34 per cent respondents advanced this view, citing the example of Rupali Bank. Less risk-averse investors trade in the market for capital gains and they follow the market trajectory with sophistication. On the other hand, more risk-averse investors trade mostly by following advices of merchant banks and brokerage houses instead of fundamental analyses.

The calculated value of χ^2 at 5% level of significance is smaller than its critical value. This shows that the variables are independent meaning no statistical interdependence among variables.

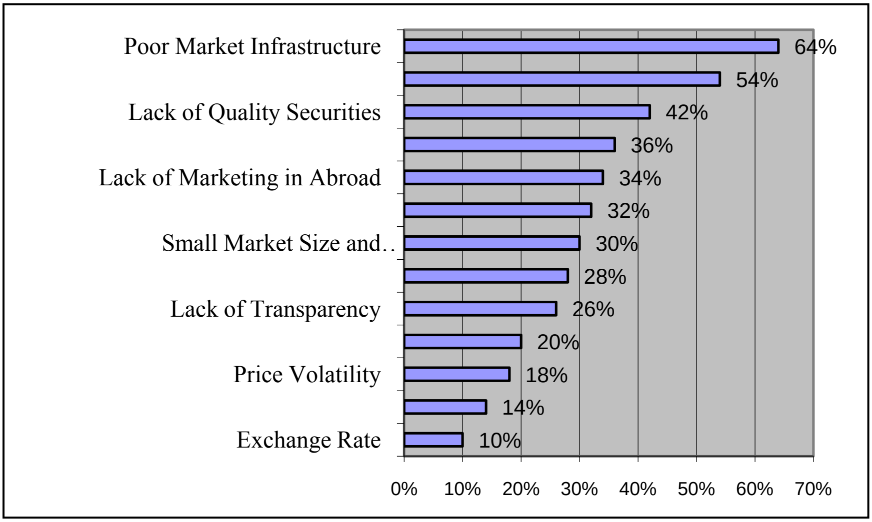
Reasons for Lack of Foreign Portfolio Investment

An important class of investors that is absent from Bangladesh's stock market is foreign investors. Net foreign investment amount is very small and sometimes negative, as earlier shown. Numerous impediments discourage them from participating in Bangladesh stock market.

Poor market infrastructure discourages foreigners to invest here, as claimed by 64 per cent of the respondents. Clearing, settlement and depository system must be developed further and reinforced. Issues such as activating Over The Counter (OTC) market, reducing settlement and clearing time, introducing online trading system, creating credit rating culture, etc. are required to entice foreign portfolio investment.

Political instability sends a negative signal to foreign investors. Fifty four per cent of the respondents viewed that political turmoil act as a psychological deterrent to foreign investors.

Figure 5: Reasons for Thin Foreign Portfolio Investment (n = 50)



Source: Survey Results

Foreign investors become confused if government regulations are not transparent. 36 per cent of the respondents offered this opinion. They said that foreign investors need to spend an excess amount of Tk 2000 per application compared to local investors as draft fees. BB's commission to send money to Bangladesh and fees for refunding money for an unsuccessful applicant are the reasons for this excess amount. Regulators should attempt to remove this anomaly.

Around 30 per cent of the respondents consider small size of the Bangladesh stock market as a major cause for reluctance of foreigners to invest here. Market capitalization of DSE as percentage to GDP was 15.87% in 2007. In contrast, the market capitalization as percentage to GDP in Colombo, Karachi and Bombay stock exchange was 24.32%, 47.87% and 166.9%, respectively. However, one should keep in mind that enhancing participation of foreign investors may increase market capitalization.

Foreign investors consider country-specific risk before investing their money in portfolios. Twenty eight percent of the respondents agree on this view. Recently, Bangladesh Bank has initiated some measures to mitigate this risk level. It is commonly felt that Bangladesh needs to build a good national image globally to attract a greater volume of foreign investment.

Gradual depreciation of Bangladesh Tk. vis-a-vis other currency is not favorable to foreign investors. This is perceived by around 10 per cent respondents. Foreign investors pay close attention to timing of their return conversions based on the anticipated exchange rate movements. When rates of return earned in Bangladesh are translated into a stronger currency, the adjusted rates of return are lower.

Some other reasons which have emerged from the responses as barriers to attract foreign portfolio investments in Bangladesh are common to both local and foreign investors, as stated earlier.

The calculated value of χ^2 at 5% level of significance is larger than its critical value. This shows statistical interdependence among the variables.

Equity Market: Issuers' Opinions

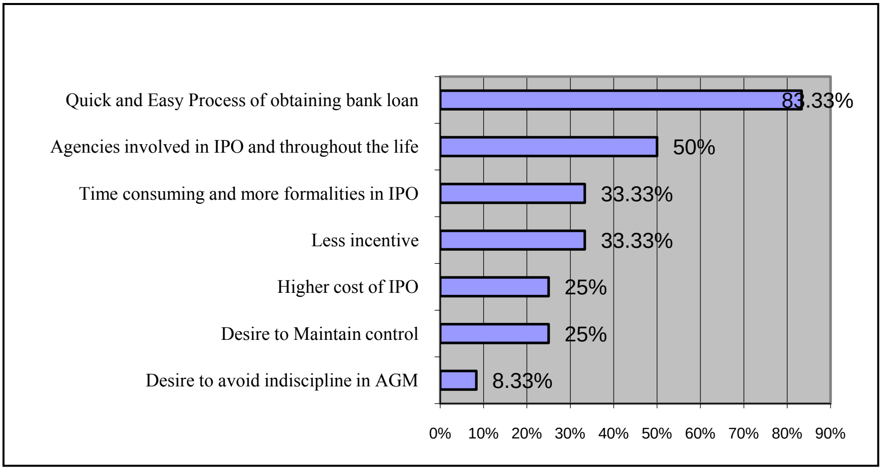
Reasons for Dependency on Bank-Financing over Equity-Financing

The demand for stocks seems to far exceed their supply. 78,166 (Seventy eight thousand one hundred sixty six) companies are registered as private limited companies with the Registrar of Joint Stock Companies & Firms and 2,795 (two thousand seven hundred ninety five) companies as public limited companies. However, only 293 companies are in the secondary market. Small and mid-sized enterprises, major industrial base of Bangladesh are immune to external shocks, and they do not issue equities to raise capital. Readymade garments industry is not in the purview of the capital market. The market needs more and more issuers with good securities. It may be difficult to bring more issuers without creating an enabling environment for them.

Quick and easy process of obtaining bank loans is a major cause for overdependence on bank financing. About 83 per cent of the issuers and 33 per cent of the prospective issuers concur on this view. Commercial banks necessarily should not be in a position to provide adequate long-term project financing due to deposit-duration and loan maturity mismatch. Traditionally, they provide such financing largely through annual rollovers. Influential borrowers are very quick to get loans as banks ask for less disclosure requirements and relaxed regulations in lending. Furthermore, lower cost of borrowed funds from banks as compared to uncertain higher returns on equity capital convinces business firms to borrow from banks instead of utilizing the equity market. Respondents borrowers were silent regarding one more commonly known cause which encourage them to borrow from banks instead collect money from the equity market is that they may get waiver of a loan interest payment and even can deceive on repaying bank loans. But this is not possible for equity issuers.

Around 33 per cent of the issuers felt that raising capital directly from the market is time consuming and requires compliances of numerous formalities. As they opined, it takes about 6-8 months to collect funds through IPOs. It is interesting that prospective issuers' voices are more pronounced in this regard. 75 per cent of them mentioned these lengthy and complex procedures for their reluctance to seek equity financing. Starting from the preparations of different documents and ending with the listing of DSE and CSE makes using capital market for raising funds a cumbersome process.

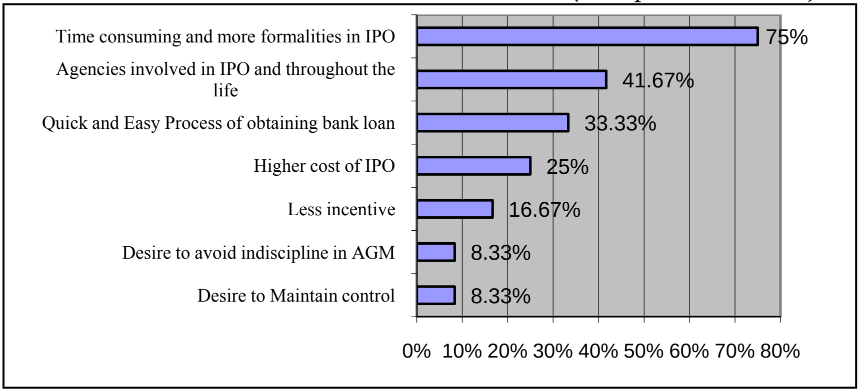
Figure 6: Reasons for Dependency on Bank Finance over Equity Finance (Issuers)



Source: Survey Results

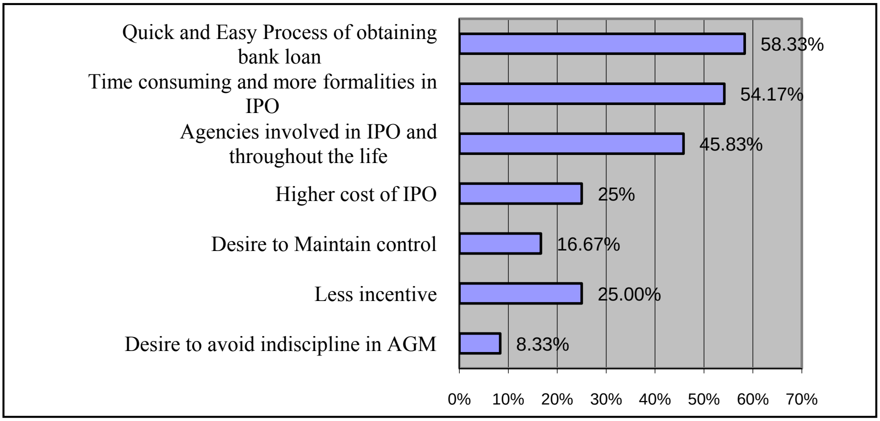
Figure 7: Reasons for Dependency on Bank Finance over Equity Finance

(Prospective Issuers)



Source: Survey Results

Figure 8: Reasons for Dependency on Bank Finance over Equity Finance (Total)



Source: Survey Results

The involvement of different agencies namely SEC, DSE, CSE, CDBL, underwriters, credit rating agencies (in case of issuing right share) in pre- and post- IPO stages discourage issuers to go public. 50 per cent of the issuers and around 42 per cent of the prospective issuers agree on this view. They feel that these agencies need to play an integrated and active role in simplifying the bureaucratic intricacies and institute rules that would provide incentives to the existing as well as the prospective issuers. A respondent commented that the cooperation extended by banks cannot be expected from SEC and DSE even in dreams.

The high cost of Initial Public Offerings (IPOs) seems to be almost prohibitive to the issuers. 25 per cent of the issuers and prospective issuers experienced this. Issue costs, already seen earlier, reach around 5 per cent of issue amount in case of raising amount of Tk. 20 crores and below. In contrast, a borrower incurs very low cost for preparing and submitting a proposal to banks for obtaining loans. As a result, they prefer bank loans to issuing IPOs for project financing.

Twenty five per cent (25%) of the actual issuers of IPOs and around 8 per cent of the prospective issuers confessed that they do not want to lose control of the firms and to make themselves accountable to the equity investors and the regulatory authority. It is widely accepted that the culture of family-owned conglomerates dislike being accountable or transparent.

Incentives for private sector entrepreneurs to access the capital market should be more attractive according to 33 percent of the actual issuers and 17 percent of the prospective issuers, such as tax free dividend income from Public Limited Company (PLC), elimination of double taxation, tax holiday and granting Commercially Important Person (CIP) status to the sponsors of PLC. Shares with smallest denomination (say with paisa one/Tk. 1) like US penny stocks may be made available with a view to bringing them in the equity market. Regarding inclusion of foreign issuers and local big industries, regulations should be made which are compatible for licensing or registration. After a certain time or after reaching a certain stage, they may be allowed to use the capital market formally to raise funds.

Indiscipline in AGM deems a nuisance to entrepreneurs. Outside investors who are a minority in number and more interested for short-term benefits create indiscipline in AGM, an opinion shared by 8.33 per cent of the issuers and 8 per cent of the prospective issuers. Family-owned conglomerates do not prefer opening their business to unpredictable behavior of external investors.

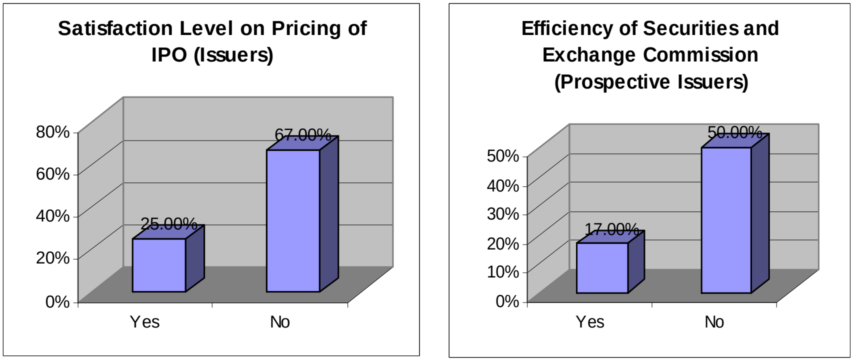
The calculated value of $\chi 2$ at 5% level of significance is larger than its critical value. This shows statistical interdependence among the variables exists. However, generalization should be made cautiously as sample size for issuers is not large.

Pricing of Primary Shares

The primary reason why issuers do not count much on the capital market is that they do not get proper prices for their shares. Almost 67 per cent of the issuers and the same percentage of prospective issuers are not satisfied with the current pricing mechanism of primary shares. They claimed that price shoots up manifold initially after trading begins against the face value and benefits are reaped by the IPO lottery winners instead of the issuers. This is also supported by the evidence that average trading price is more than offer price by 2 to 8 times (Table 7, Chapter: 1). To solve this problem, Direct Listing Rules have already been introduced. Under these rules, the price of a share is made by the prospective investor directly in the secondary market and it results in best value of the floated share regarding the issuers. In direct listing, 10 per cent of the shares need to be sold within the first 30 days so that both individual and institutional investors can participate in the price discovery process. However, a limited amount of shares and large participation of individual investors may inflate the share price.

Book Building System (one more price discovery system) is going to be introduced by the SEC. With this, the underwriter attempts to determine at what price an IPO will be offered, based on demand from eligible investors registered with or approved by the commission. Both these schemes will encourage private sector entrepreneurs to list their companies with the stock exchange. However, the market watchdog should take care of timing and cost of issuing shares following the price discovery mechanism.

Figure 9: Satisfaction Level on Pricing of IPO



Source: Survey Results.

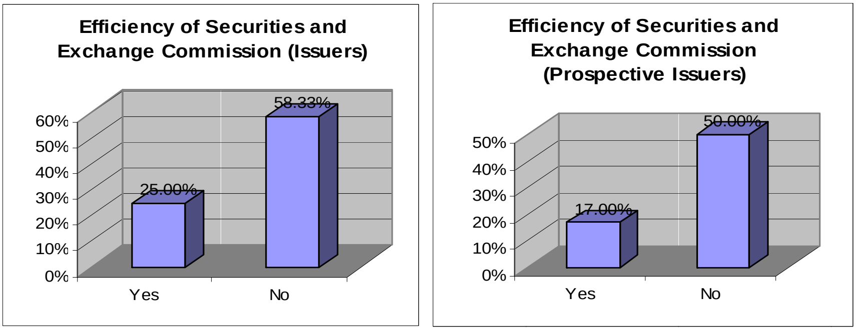
Securities & Exchange Commission and Equity Market

The SEC is persistently trying to keep the capital market active by monitoring and supervising its activities, simplifying rules and regulations, and notifying guidelines on corporate governance on comply or explain basis. But issuers are not happy with the SEC. Twenty five per cent respondents are satisfied with the activities of the SEC whereas almost fifty eight per cent are unhappy. Issuers viewed that authenticated financial reporting is not rewarded by the SEC as it has primarily been concerned with making rules to regulate stock trading, not financial reporting. Furthermore, issuers expressed some concerns on SEC's corporate governance conditions[3] with which listed companies are to act on 'comply or explain' basis. They opined that complying is not easy for mid-size listed companies and these conditions may act as barriers to attract relatively mid-size enterprises.

BAPLC has raised issues relating to the power of SEC under section 2CC of the Ordinance 1969 which is equated with Special Power Act of Government, as they mentioned. They added that this section has kept the prospective sponsors away from entering the capital market, which is evident from the fact that, since enactment of section 2CC, there has been a very low issuance of IPOs from the manufacturing sector. Moreover, for delisting SEC should separate genuinely suffering PLCs from the companies with wilful defaults in terms of declaration of dividend and arrangement of AGM. In this regard, a team constituted with SEC, BAPLC, DSE and BB may identify genuinely suffering companies and can give reasonable time before delisting. The future of the investors' funds of the de-listed companies is also a cause of concern to the investors. SEC may ask issuers to repay the investors money at least at the prevailing market rate during the delisting time. SEC also takes time for clearance of different issues. Sometimes, issuers feel that the queries of the SEC are unnecessary. It is true that the manpower of SEC is not sufficient to carry out all its activities promptly.

3 Corporate governance conditions are: (a) the appointment of at least one independent director on the board, (b) the formation of an audit committee comprising of at least three members, (c) certain accounting and finance qualification or experience for the chairman of the audit committee, and (d) appointment of a chief financial officer, a head of internal audit and a company secretary and the fulfilling of the position of the chief executive officer and the chairman of the Board by separate persons (SEC, 2006).

Figure 10: Efficiency of Securities and Exchange Commission

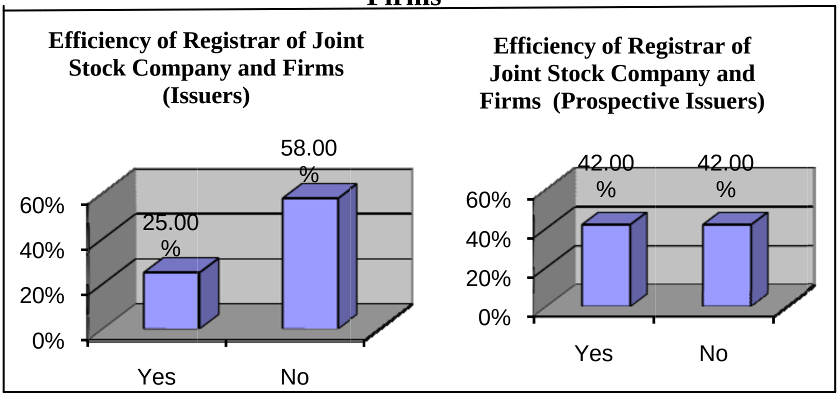


Source: Survey Results.

Registrar of Joint Stock Companies and Firms (RJSCF)

RJSCF is the first place where an issuer starts his journey from with an intention for listing with the stock market. Around 58 per cent of the issuers and 42 per cent of the prospective issuers expressed negative feelings about the efficiency of RJSCF. An issuer has to pay fees for name clearance, stamp and fees for registration, fees for return filing, and fees for issuance of certified copies. However, there are serious allegations about side payments or 'speed money' needed to move files in RJSCF. One respondent expressed dissatisfaction saying that it takes three months for registration, although it should take no more than fifteen days only.

Figure 11: Efficiency of Registrar of Joint Stock Company and Firms

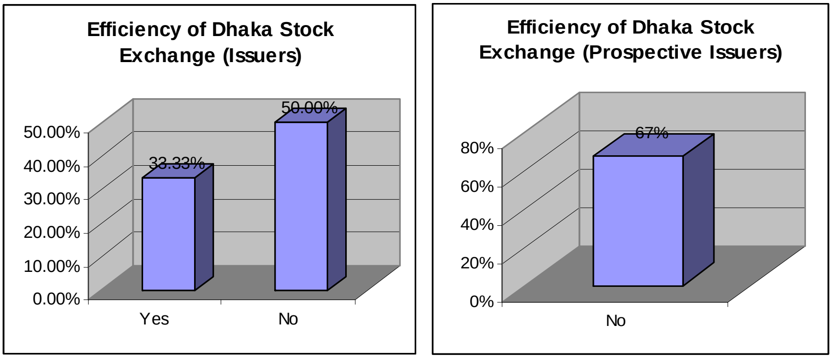


Source: Survey Results

Dhaka Stock Exchange

Regarding the efficiency of DSE, 50 per cent of the issuers and around 67 per cent of the prospective issuers have expressed dissatisfaction. Respondents opined that besides documents, the board of DSE can take decision regarding listing and non-listing of the company within 75 days. This seemed more time-consuming than necessary to the respondents. They felt that trading facility is not at the door-steps of investors, and the service ability can easily be improved by increasing DSE's capacity to deal with trade volume and instructing Brokerage House for to open more branches. Recently, hundreds of stock investors in Barisal City alone have incurred a loss in tens of millions of Taka because trading was suspended for eight days due to technical glitches in online trading with DSE. Moreover, introducing internet-based trading, setting up an online-based National Settlement and Clearing House, and upgrading the IT infrastructure are important steps needed to attract issuers for listing with DSE.

Figure 12: Efficiency of Dhaka Stock Exchange



Source: Survey Results

Corporate Bond Market

The culture of indirect financing through banks is fairly deep- rooted for corporate borrowers in Bangladesh. However, relying exclusively on this single source for access to capital can be problematic in terms of liquidity due to a lack of diversification in the sources of funds. Bank-based financing system alone cannot finance all long-term and lumpy investments. Direct financing through capital markets is supposed to be relatively more efficient as the cost of capital is market determined and it insulates borrowers from turmoil in the banking sector. Lian (2002) writes “The Asian Crisis showed that an overdependence on the banking system could exacerbate problems for borrowers. A deep and liquid debt market would offer borrowers the flexibility to diversify their sources of funding and provide them with a good alternative source to raise funds for matching any expenditure needs. Moreover, the development of debt market would make available to investors a wider choice of assets of different credit risk and maturities”.

The size of the debt market of Bangladesh is tiny relative to other South Asian countries. In June 2008, the market value of the outstanding volume of bonds (including government treasury bills) was 5.5 per cent of GDP that compared poorly with 43.4 per cent in India, 29.8 per cent in Pakistan and 39.5 per cent in Sri Lanka. Furthermore, Bangladesh debt market is, to a significant extent, dominated by government bonds whereas corporate bond market is nearly invisible. The number of government bonds in June 2008 was 84 whereas the number of corporate bonds was only 9. The corporate bonds and debentures together constituted only around 2 percent of the market capitalization of all types of bonds in 2008.

Table 13: Debt Financing: Govt. Bonds and Corporate Bonds

Period (as on June)	Number of Securities		Total Issued Capital of Securities (Taka in Million)				Market Capitalization of Securities (Taka in Million)			
	Govt. Bond	Corporate Bond & Debenture	Govt. Bond	% of Total	Corporate Bond & Debenture	% of Total	Govt. Bond	% of Total	Corporate Bond & Debenture	% of Total
2005	18	8	13,587	99	140	1	11,589	95	576	5
2006	26	8	21,032	99	140	1	20,040	97	576	3

2007	44	8	80,553	99.8	140	.20	79,561	99	576	1
2008	84	9	175,403	98	3140	2	175,403	98	3503	2

Source: DSE Monthly Reviews

In Bangladesh, the first private sector debenture was issued in 1987 by Apex Tannery. Since then, there has been an uneven trend of private issuance. Around 17 private corporate issuers participated in the secondary market to raise debt finance and 6 corporate issuers raised finance through private placement during a period of 12 years (1987-1999)! Private corporate issuers participated in the secondary market by placing a major portion of their securities in the private placement market. However, corporate issuance in the secondary market has been completely non-existent since 1999 (Appendix 2).

The private placement market for corporate securities in Bangladesh has been growing rapidly since 2001 (Appendix 2). Since the introduction of the Credit Bridge Standby Project Facility in 2001, financial institutions emerged as the main issuers of debt instruments through private placement with the consent of the SEC. A total of Tk. 5,178.58 million worth of corporate securities were placed privately between 2001 and 2004. However, the issuance of debt instruments was limited to a few blue chip financial institutions and a private commercial bank. Since 2005, corporate units resumed to collect funds by issuing bonds and debentures. Currently, corporate units are more active in collecting debt funds than banks and other financial institutions (Appendix 2). However, all except Islami Bank Bangladesh Ltd. (IBBL) Mudaraba Perpetual Bond are issued in the private placement market.

Reasons for Non-existence of Corporate Bond Market in Investors' Opinions

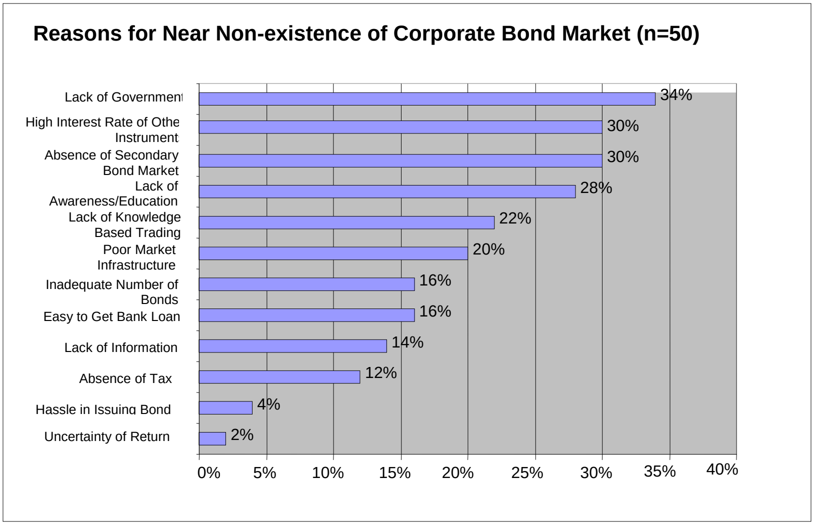
Government initiatives are required to nurture the corporate bond market in Bangladesh, which can act as a complementary source of financing to bank-financing. However, 34 per cent of the respondents viewed that government initiatives alone are not enough. They added that the government can contribute in two ways: (i) offering a vibrant government bond market, and (ii) creating an enabling environment for the corporate bond market. It seems government now only focuses on forming an active government bond market. Eighty four (84) government bonds were available in June 2008. They were traded in the primary market through auctions. Trading of existing government securities is, however, almost dormant in the secondary market. A good government bond market can facilitate corporate bond market by constructing a benchmark yield curve, allowing market-based interest rate, innovating different financial products, ensuring a speedy payment and settlement system, and more importantly, by educating prospective issuers, investors and primary dealers (PDs). Responses reflected that creation of an enabling environment with transparency in the public sector is an imperative.

The high interest rate is a barrier to the corporate bond market. 30 per cent of the respondents among investors hold this view. The government still borrows through various national savings schemes at high interest rates and banks collect deposits at quite high interest rates in competition with government securities. High interest rates deter public borrowings by the corporate bodies, thereby thwarting the development of a corporate debt market. Thirty per cent of the respondents felt that the absence of a secondary bond market is the major reason for the nonexistence of a corporate bond market in Bangladesh. By secondary bond market, they refer to an organized secondary market which includes the OTC market, and a private placement market for corporate bonds.

Twenty eight per cent of the respondents felt that awareness, education and some convincing may be needed to attract right issuers and investors to the corporate bond market. State Owned Enterprises (SOE), multinational companies, infrastructure projects and large as well as medium enterprises may be targeted for this purpose. On the other hand, as institutional investors are the natural suppliers of funds in the debt market, the corporate sector of Bangladesh, for instance, can initially target insurance companies, provident funds and pension funds of various organizations, mutual funds, etc.

The lack of knowledge-based trading, even for government bonds, is an important reason for the corporate bond market remaining inactive according to 22 per cent of the respondents. Bangladesh Bank has issued nine PD licenses but these are yet to fully start their activity. In the government bond market, PDs can play an important role in activating the secondary market for treasury bills and government securities. This would require more liquidity and greater depth of the market by facilitating price discovery and turnover, decreasing buy-and hold mentality, and by developing underwriting and market making capabilities. Later on, PDs can spread this knowledge-based trading to the corporate sector.

Figure 14: Reasons for Near Nonexistence of Corporate Bond Market (n= 50)



Source: Survey Results

The lack of innovative products has kept the market unattractive as opined by 16 per cent of the respondents. Securities bearing zero and fixed coupons, and bonds following Islamic *shariah* only are available currently in Bangladesh. Bonds like Treasury Inflation Protected Securities (TIPS), Islamic Bonds (SUKUK Bond), High-Yield Bonds (HYB), and Deep Discount Bonds may help formation of corporate bonds market in Bangladesh. The government may initially issue these types of bonds targeting their development projects. Later the government can facilitate various sector corporations to issue these types of bonds. Lessons can be drawn from China in this respect.

The lack of information pertaining to current trading opportunities and recently completed trading is a limitation of the market as perceived by 14 per cent of the respondents. In the market, the pre- and the post-trade information quality is poor. Acquiring information about the buying or selling or quality of assets of recently completed executions seems costly and time consuming.

The uncertainty of return is also a cause for concern to the investors, although very few (2%) of the respondents considered this as a factor. Most of the bonds, issued earlier, have failed to honor interest and principal payment obligations as per the original schedule. Respondents opined that trustees should act judicially in bringing legal actions against the issuers when circumstances dictate. Other barriers mentioned are poor market infrastructure (20%), easy to get bank loan (16%), absence of tax incentives (12%), and hassles in issuing bonds (4%).

The calculated value of χ^2 at 5% level of significance is larger than its critical value. This shows statistical interdependence among the variables.

Reasons for Dependency on Bank Finance over Corporate Debt Finance in Issuers' Opinions

To make corporate bonds attractive to investors, credit standing of the issuing companies reflected in grading by the Credit Rating Agencies should be reasonably high. For example, Asian Institutional Investors are required to invest in bonds rated not lower than 'A' and multinational development banks operating in Asian Regime can only invest in bonds rated 'AA' or above. Rating issue is, therefore, important for corporate bond issuers in order to access institutional savings. However, credit standing of most of the private business entities and SOEs is not up to the mark. Moreover, rating culture is almost absent in Bangladesh corporate sector. These are the opinions of 25 per cent of the respondents among current issuers and 50 per cent of the respondents among prospective issuers.

Availability of lower cost bank-based finance makes it more attractive compared to the corporate bond market, which stands in the way of the development of the bond market. 17 per cent respondents among issuers and 50 per cent respondents among prospective issuers advanced this opinion. Because of dominance of relationship-based bank finance, bank loan is easier to secure. This financing is also cheaper on account of imperfections in the capital markets. As a result, major borrowers rely heavily on bank finance.

Statutory restriction on the issuers of fixed-income securities, as viewed by 17 per cent and 33 per cent of the respondents respectively among current and prospective issuers, is another barrier to the corporate debt market. The way the minimum size of the new debt issues is fixed, it effectively keeps small business borrowers out of the corporate bond market. In a normally operating capital market, financial leverage decision should be left to individual corporate issuers, and underwriters without government regulations.

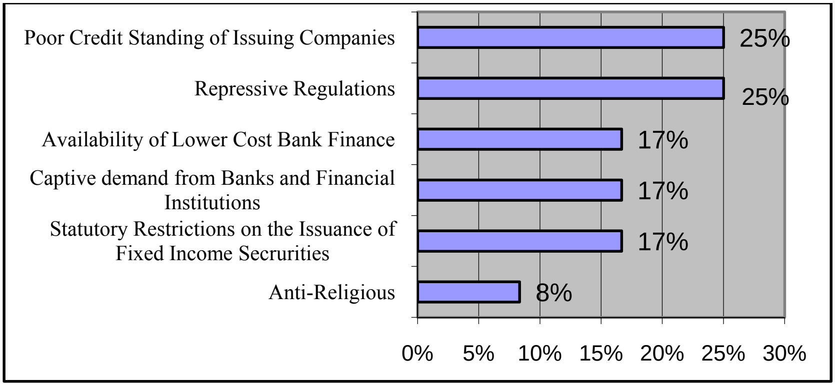
Twenty five per cent of the respondents viewed that repressive regulations create hurdles for the corporate bond market. Bank Companies Act and Financial Institutions Act delineate the issuance of bonds as a deposit-taking activity which, therefore, needs a prior approval by the Bangladesh Bank and then by the SEC. This dual approval frequently causes long delays. In addition, SOE bond issues must have approval of the relevant ministry which requires more time and formalities to be met.

Captive demand from banks and financial institutions limits the demand for bonds. Around 17 per cent and 58 per cent of the respondents respectively among current and prospective issuers are of this opinion. Government bonds, representing around 98 per cent of the entire bond market are sold to banks and financial institutions at a rate lower than the market rate. For example, the coupon rate of T & T bonds is 7.5% whereas Grameenphone is going to issue bonds at 14.5%. Banks and financial institutions buy government approved bonds to satisfy Statutory Liquidity Ratio (SLR). But individual & institutional investors are not interested in buying government bonds at a lower rate. A strong investor-based bond market was not, therefore, created. Furthermore, banks and financial institutions are not eager to buy corporate bonds as they are not considered as part of SLR. One lesson can be learned from the primary and the secondary markets for Japanese government bonds that became active in 1977. This was the case when the Japan government stopped relying on captive financial institutions and began offering new issues of government securities in an open and competitive manner (Rhee 1993).

The bond Market is considered to be against religious beliefs by a large segment of the society, as opined by 8 per cent of the respondents. As it is an interest-bearing instrument, bonds may have some limited prospects and appeals in Bangladesh.

The calculated value of χ^2 at 5% level of significance is smaller than its critical value. This shows that the variables are independent meaning no statistical interdependence among variables exists. However, generalization should be made cautiously as sample size for issuers is not sufficient enough.

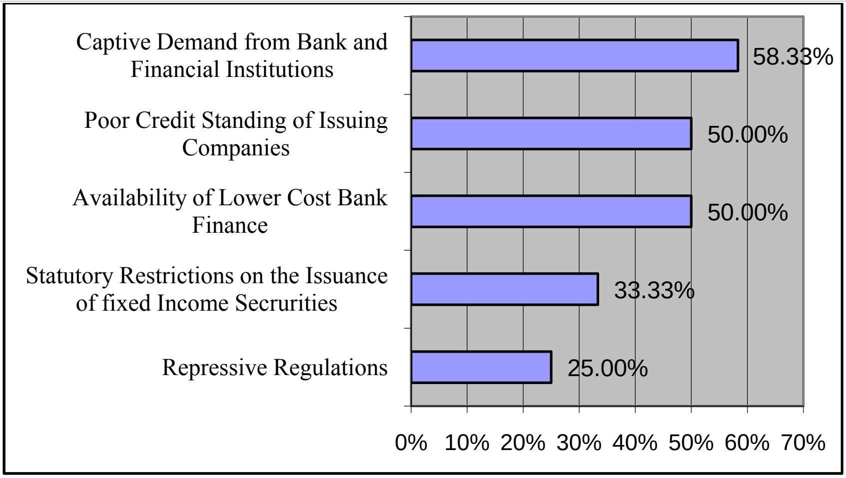
Figure 15: Reasons for Dependency on Bank Finance over Debt Finance (Issuer)



Source: Survey Results

Figure 16: Reasons for Dependency on Bank Finance over Debt Finance

(Prospective Issuer)



Source: Survey Results

Friendliness of Market Infrastructures for the Corporate Bond Market

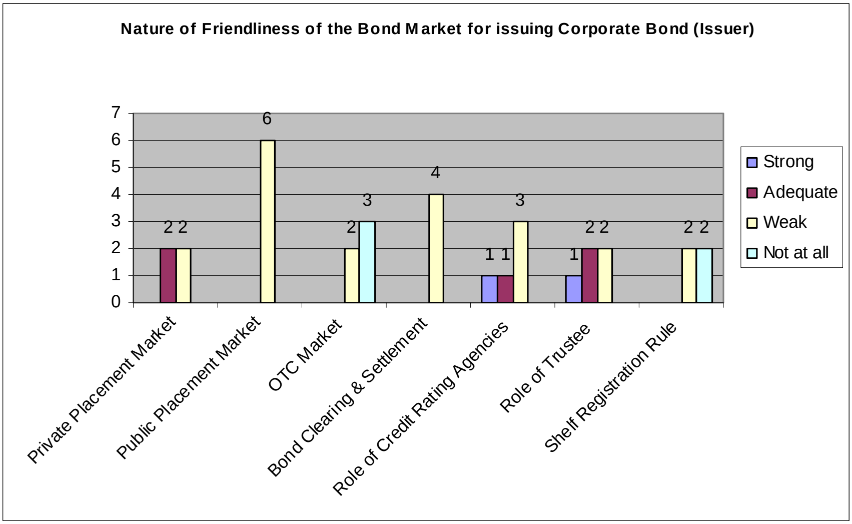
Private Placement Market

The corporate sector used private placement market to raise funds either for total debt funds or for a portion from the private and the remaining from public sectors till 2000. Two out of 12 issuers feel that the environment of this market is strongly favorable. On the other hand, 5 out of 12 prospective issuers indicate that the private placement market environment is not friendly enough for floating new bonds. The private placement market may be encouraged at the initial stage through fiscal and regulatory reforms for attracting issuers so that they can sell issues more quickly with less distribution costs and regulatory formalities. This will enable them to issue debts publicly in the future. Shapiro and Wolf (1972) show that 95 of 138 companies (69%) that are now selling straight debt issues publicly first sold in the private placement market in the USA.

Public Placement Market

The public placement market is almost inactive in Bangladesh. Recently, only Islamic Bank Mudaraba Perpetual Bond has been floated in the public market. 6 out of 12 issuers and 5 out of 12 prospective issuers advanced this view. Secondary market trading is observed only in the first few weeks after issuance. Later on, trading is observed very rarely. An active public placement market is essential. Authorities should, therefore, provide fiscal and regulatory incentives to keep it active. The secondary market activity of USA's corporate bonds is also fairly limited. It is due to the naive investment practices, and strong affinity for buy-and-hold investment strategies.

Figure 17: Nature of Friendliness of the Bond Market Issuing Corporate Bond (Issuer)



Source: Survey Results

OTC Market

The OTC Market, popularly used for the secondary market corporate bond trading, does not exist in Bangladesh though, Securities and Exchange Commission (Over-the-Counter) Rules, 2001 was promulgated by the SEC in 2002. 5 respondents among current issuers and 4 respondents among prospective issuers informed its non-existence and expected its introduction as quickly as possible. Transparency in pricing does not exist in the OTC market. This opaqueness in pricing has contributed to wide bid-ask spread, making transactions unnecessarily costly and inefficient to investors. A trading mode concerning OTC may be established to ensure proper assessment of counterparty risks and pricing flexibility of corporate bonds.

Bond Clearing and Settlement

The bond clearing and settlement system is weak according to 4 respondents each from current and prospective issuers. Only one respondent among prospective issuers considered clearing and settlement system as adequate. The delivery versus payment (DVP) system used for government bonds should be introduced for corporate bonds too. Moreover, the clearing and settlement system for equities and that for corporate bonds must be linked to facilitate redemption of fund units. The Asian Bond Fund has successfully accelerated linking of these two systems in some markets. Bangladesh can draw lessons from this practice.

Role of Credit Rating Agencies

The importance of bond ratings to both issuers and investors is always significant. Of 12 issuers, one considered the current role of credit rating agencies in Bangladesh strong. One favored it as adequate and three indicated it to be weak. Among 12 prospective investors, 3 felt that the current role of credit rating agencies is weak. Nonetheless, Bangladesh lacks a rating culture. Though the two credit rating agencies working in Bangladesh are struggling to establish their credibility, regulatory authority of Bangladesh can designate reliable rating agencies in line with Nationally Recognized Statistical Rating Organizations (NRSRO)[4]. This will be based on agencies' organizational structure, financial independence, quality of staff, rating procedures, and internal procedures in using non-public information. Regulatory authority of China requires rating agencies to comply with specified performance and training standards and regularly monitors their compliance with those standards.

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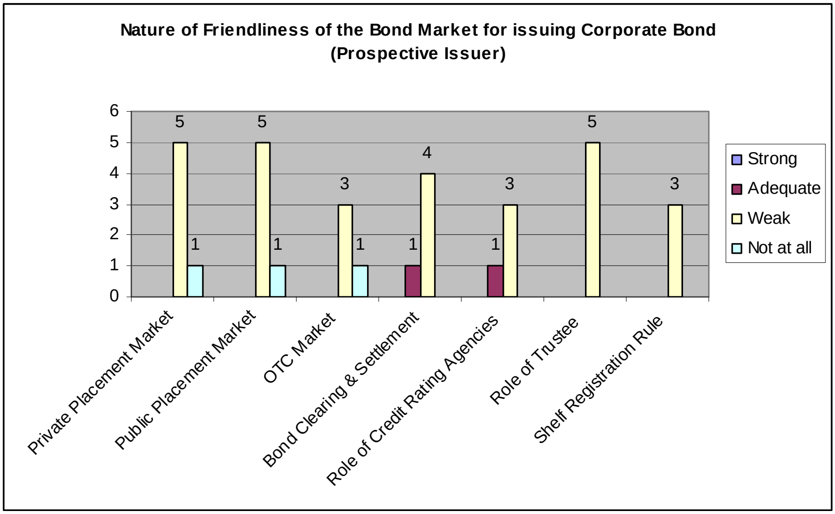
4 Currently, there are three NRSROs in the USA- Moody's Investors Service, Inc (Moody's); Fitch, Inc. ('Fitch'); and the Standard and 'Poor's division of the McGraw Hill Companies Inc. ('S & P').

Figure 18: Nature of Friendliness of the Bond Market for Issuing Corporate Bond (Prospective Issuer)



Source: Survey Results

Role of Trustee

The trustee should perform three important activities: (i) bond certification ensuring that bond issue has been drawn up in accordance with all legal requirements; (ii) overseeing the issue assuring bond holders that the issuers are meeting all of the prescribed functions specified in the indenture and (iii) taking legal action against the issuers if they fail to meet interest and principal payments or satisfy other terms specified in the indenture. Regarding the role of the trustee, 1 issuer marked it as strong, 2 issuers as adequate and 2 issuers as weak. Apart from these, 5 prospective issuers felt that the role of trustee in favor of investors is weak. In Bangladesh, the Investment Corporation of Bangladesh (ICB) and a few insurance companies usually act as trustees. However, issuers demand commercial banks, either local or foreign, with a separate professional trust department[5] to be permitted to act as trustee

5 An issuer of the USA typically considers a number of qualities in selecting a trustee such as understanding of complex documentation and complex cash flow, holding the necessary systems and technical capabilities to handle the requirements, retaining the highly experienced legal counselors and affiliating with consulting firms.

particularly for public debt issues. The SEC of Bangladesh may act as a watchdog to ensure that bond indenture clearly delineates the right of the bond holders, that there are no conflicts of interest among bond holders, trustee, and issuers, and finally, that the trustee acts judicially in bringing legal actions against the issuer as and when conditions dictate.

Shelf Registration Rule

The floating of a corporate bond in the market is a bit complex as a process involving preparation of documents, selection of a trustee, registration with the RJSCF and the SEC and formation of a selling group[6]. These procedures increase the floating costs. To reduce the procedures and minimize costs, Shelf Registration Rule may be introduced. Both issuers and prospective issuers mentioned it as nonexistent. So, authorities may consider introducing this technique for creating interest among current issuers and prospective issuers.

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6 In selling the bond issue, the underwriter forms a selling group with other investment banker/dealers under an agreement (describing period of time to sell the issue, commissions to charge and restricting such as prohibiting members from selling below a certain price, etc.) in order to sell the issue to a number of dealers who in turn sell issue to their clients.

7

POLICY RECOMMENDATIONS

Equity Market

Smooth Operation in the Primary Market

There has been an enormous response to IPOs in Bangladesh in recent years. But, investors still feel uncomfortable in the primary market for the following reasons: depositing the full amount with applications, delay in holding lottery, limited number of bankers to the issue and hassle in collecting refunds. Paying 20-25 per cent of the total money during application time and remaining amount within 10 days after allotment will ease the pressure on investors. Organizing the lottery should ideally be ensured within three weeks and the whole process should be completed within one month. Increasing the number of bankers to the issuers including locations of bank branches and provision of accepting online application will ensure smooth participation of all types of investors. Moreover, refund amount should not be delayed on the grounds that names are not properly written in the issuer book or because of the existence of multiple BO accounts in the same name or because of several applications made by the same investor. In addition, the allegation that issuers in collaboration with banks delay the refund intentionally in order to reap undue pecuniary benefits through re-investment deserves thorough investigation and immediate remediation.

Margin Loan Ratio

Frequent changes of the margin loan ratio and compelling clients to sell off shares to adjust loans destabilize the market. The SEC may consider instituting a permanent policy for the margin loan ratio and let merchant banks lend investors within their own parameters. To this effect, ‘maintenance margin’ or ‘credit balance’ rule may be considered. Under maintenance margin, if the stock price, for example, declines below 25 per cent, investors will receive a margin call to provide more equity within a given time. The merchant banks may have the right to sell off investors’ shares after expiration of the deadline to replenish the balance due. Under the credit balance system, investors must place collateral with the merchant bankers for the amount not less than the initial margin. The amount of collateral in excess of a total loan used to buy securities for each investor is called the credit balance and this should bear interest. On the other hand, if the total debt is greater than the collateral value, then there is a debit balance. The investor should pay interest on this balance to the merchant banks. However, the currently allowed capacity of NBFIs to hold maximum exposure (loan to investors, own investments and commitment for underwriting) requires enhancement. They are not permitted to leverage more than five times their paid-up capital.

Rumors

Retailers make investment decisions mostly based on rumors rather than company – specific fundamentals. This makes their investment very risky. The SEC can notify investors immediately about the securities undergoing large deviations in terms of price and volume with sound justifications. Moreover, merchant bankers and brokerage houses can organize regular awareness programs for investors to help them make rational investment decisions and to warn them in advance against rumors to mitigate possible stock market over-reactions/under-reactions. Gradually, investors should be made well-educated about sophisticated investment tools with instant and simultaneous access to market information for greater efficiency.

Market Volatility

High price volatility is a matter of serious concern to investors. Any policy decision on volatility – controlling mechanisms must be supported by empirical evidence. No convincing empirical work has been done to date on the effectiveness of the currently used mechanisms, trading halts and daily price limits in mitigating market volatility. A comprehensive empirical research work on the efficacy of currently used mechanisms is thus warranted. Suitability of other mechanisms including margin regulations, price stabilization funds and securities transaction taxes merit proper attention of the policy makers.

Multiple BO Accounts

Genuine investors should not suffer from harassments because of multiple BO accounts held by unscrupulous investors. Here, proper procedures of opening bank accounts and maintaining them should be in place. Meticulous examinations of required information in the BO accounts form, namely, passport/voter ID number, driver license and bank statement will disable unscrupulous investors to open fictitious multiple BO accounts. Importantly, many fake BO accounts opened at the initial stage of this provision should be detected and closed immediately. Furthermore, no individual shall be allowed to use another investor's BO account for investment purposes.

Expansion of the Issuer Base

The market suffers from a dearth of quality securities. To overcome this problem, quality issuers need to be attracted. In the opinion of the researchers, Bangladesh has the potential to do so. Profitable state-owned enterprises, multinational corporations and large home grown private enterprises with clean and strong balance sheets should be listed with the SEC. Issuance of SOE securities will include transparency in their operations besides multifold expansion of the equity market. The government can improve guidelines relating to the capital structure of SOEs making it similar to those for financial institutions and banks. In addition, complete or partial issuance of SOEs can be possible through public offerings in the market. Parent companies of multinational subsidiaries are listed in developed equity markets. However, it will be a difficult task for Bangladesh unless the local stock markets effectively enforce a unified and transparent corporate governance system.

Large private businesses should not be forced to be enlisted without creating an enabling environment for them. Abolition of excess fees for IPOs, reduction of time needed to complete the IPO process and reducing the high taxes in place are likely to help create such an environment. In addition, SMEs should be encouraged to be listed with the stock exchanges under rules and regulations that are separate from large private sector firms, as appropriate.

Fair Value of Share

An important aspect of a well-functioning capital market is the fair valuation of shares. Currently, this is not the case in either the primary or the secondary equity markets in Bangladesh. It has already been observed that offer prices of all shares floated in 2008 were less than average of the trading prices of the first three days by two to eight times. This implies that issuers do not get fair prices of their shares. For price discovery, in addition to direct listing rules, a book building system should be introduced quickly. Unnecessary formalities and transaction costs should also be cut down to improve market efficiency. For fair prices in the secondary market, local and foreign institutional as well as individual investors need to be enticed. These types of investors would add to market sophistication by information dissipation.

Incentives for Issuers

Reducing time taken to meet compliances of numerous formalities, lowering cost of initial public equity offerings, making dividend income from PLC tax-free, eliminating double taxation, providing tax holiday and granting CIP status to the sponsors of PLC will be helpful to the equity market's improvement. Shares with smallest denomination (say with paisa one/Tk. 1) like US penny stocks may be made available in the equity market. Regarding the inclusion of foreign issuers and local large industries, regulations should be made compatible for licensing or registration. After reaching a certain stage, they may be allowed to use the capital market for direct financing. In addition, monitoring agencies, namely, SEC, DSE, CSE, CDBL and credit rating agencies need to play an integrated and active role in simplifying the bureaucratic intricacies and remove the duplication of work in different agencies. New rules need to be instituted to provide incentives to the existing as well as prospective issuers.

Advertisement

For a vibrant market with active presence of issuers and investors, the SEC should initiate awareness, educational and promotional programmes through institutional training and advertisement in the domestic as well as the foreign print and electronic media.

Foreign Portfolio Investments

Foreign portfolio investments that are nearly absent from the Bangladesh stock market can be attracted by the creation of a favorable environment. This requires political stability, developed information infrastructure, selective deregulations, etc. Moreover, image building activities through seminars, symposium and fairs at home and abroad deserve due consideration.

Securities and Exchange Commission

The SEC is now highly active in enforcing strict rules and guidelines, trading circuit breakers and international surveillance standards to ensure fair play. The SEC should protect investors' interest and create an enabling environment for issuers. For transparency in reporting financial results, the SEC may consider an Act similar to US Sarbanes-Oxley Act of 2002. SEC may also ask issuers of de-listed companies to repay investors' funds at least at the prevailing market rate of the shares during the time of delisting.

Brokerage Houses

Brokerage houses and their branches should extend services beyond metropolitan areas. They should invest adequately in quality research to bolster stock market related credentials by providing value-added information on listed companies, their industry and the national economy in general. To make the domestic market more competitive and liquid, fixed commission rates need to be replaced by negotiable rates for trading of all sizes. Allegations, such as selling shares at high price without investors' consent and later replacing them by buying the same number of shares at convenient times, need to be investigated.

Stock Exchange

The stock exchange should shorten the time span needed for making listing decisions and improve capacity to deal with rising trade volumes. Also, a SME platform may be created within the current structure of the stock exchanges with separate rules and regulations for registration, listing and delisting. Separate trading time for SME may be required as well.

Registrar of Joint Stock Company and Firms (RJSCF)

RJSCF should be prompter in registering issuers with specific deadlines. Issues of side payment, harassments during registration and delayed clearance by RJSCF call for immediate resolution.

Corporate Bond Market

Government Initiatives

A good government bond market needs to be created to facilitate the corporate bond market architecture by constructing a benchmark yield curve, allowing a market-based interest rate, innovating new financial products, and ensuring a speedy payment & settlement system. Furthermore, efforts are needed to educate prospective issuers, investors and primary dealers. The portrayal of a government securities yield curve based on so-called risk-free interest rate is essential in order to efficiently price corporate bonds. The government may take necessary initiatives to issue treasury bonds with a few buckets of maturities extending to at least a 10- year period. Government initiative is also desirable in creating a strong issuer and investor base. Government infrastructure projects and state-owned enterprises may be persuaded for mobilizing direct financing through bond issuance. On the other hand, as institutional investors are the natural suppliers of funds in the debt market, the government should encourage them to invest in corporate bonds with good ratings.

Innovative Financial Products

The introduction of zero-coupon bonds, fixed-coupon bonds and Islamic bonds merits due consideration. Bonds like treasury inflation – protected securities (TIPS), SUKUK Bond, High – Yield Bonds (HYB) and Deep Discount Bonds may also help to lay out the corporate bond market architecture in Bangladesh. The government may initially issue these types of bonds targeting their development projects. Corporations from various sectors may be encouraged to step in later.

Market

An active market comprising of private and public placements is essential. A private placement market may be encouraged at the initial stage to entice issuers so that they can sell issues quickly with low distribution costs and fewer formalities. However, the marketability of securities is considered as a drawback of private placements, which needs to be addressed. Simultaneously, public placement market should also be there for issuers. They may be encouraged to place a certain percentage of debt securities in the public placement market and the remaining in the private placement market. Appropriate fiscal incentives and a regulatory framework will be helpful in this regard. The introduction of Shelf Registration Rules may be considered. An Over-the-Counter (OTC) market that is extensively used for corporate bond trading should be established as a secondary market.

Knowledge-Based Trading

Banks and financial institutions that already have PD licenses must be activated at least for the government bond market at the initial stage. PDs can play an important role in activating the secondary market for treasury bills and other government securities. This would gain more liquidity and a greater depth by facilitating price discovery and turnover, diluting buy-and-hold mentality, and by developing underwriting and market-making capabilities. Subsequently, PDs will use this knowledge-based trading strategy for the corporate sector.

Statutory Restrictions on the Issuers and Captive Demand

Statutory restrictions relating to financial leverage should be left to individual corporate issuers and underwriters without government regulations. A policy framework needs to be developed for SOEs in issuing bonds. This will relieve SOEs from obtaining approval of the relevant ministry in each case. In addition, a joint cell of the BB and the SEC can allow banks and financial institutions to issue bonds in lieu of the dual approval process. It will save time and reduce redundant formalities. To mitigate banks' and financial institutions' captive demand for securities, BB can approve bonds for SLR on the basis of credit rating.

Interest Rate and the cost of Bank Finance

Both the government and banks mobilize funds at high interest rate. This results in increasing borrowing cost for corporations through bond issuance. Coordination is necessary among government, regulatory authorities and banks to create a level playing field in determining interest rates. However, banks manage to lend at lower rates whereas corporate issuers need to pay more interest to bond investors. In this case, loan-default culture, and interest waiver provision should be rescinded.

Credit Rating Agencies

The importance of bond ratings to both issuers and investors is important. At the moment, two credit rating agencies are working in Bangladesh, struggling to establish their credibility. And more credit rating agencies are required. Then regulatory authorities in Bangladesh can designate rating agencies in line with Nationally Recognized Statistical Rating Organization (NRSRO) of the USA on the basis of agencies' organizational structure, financial independence, quality of staff, rating procedures and internal procedures in processing private information.

Trustee

ICB and a few insurance companies that worked earlier as trustees failed to perform their assigned duties properly. Some of the bonds, issued earlier, have failed to honour the interest and principal repayment obligations as per the original schedule since the trustee was not active in these situations. A trustee should be selected on the basis of its capacity to understand complex documentation and uncertain cash flows. There should be right systems in place with enhanced capabilities and retention of highly experienced legal counsellors. Affiliations with reputed private financial consulting firms may also be considered. Apart from strengthening the capacity of the existing trustee, commercial banks (either local or foreign) may be permitted to have a separate professional trust department for public debt issues. Moreover, the SEC and the Bangladesh Bank may act as watchdogs to ensure that bond indenture clearly delineates the rights and the privileges of the bond holders with no potential conflicts of interest among investors, the trustee, and issuers. Finally, the trustee should act judiciously in initiating possible legal actions against the issuers for any wrong doings.

Bond Clearing and Settlement Systems

The Delivery versus Payment (DVP) system introduced for government bonds should also be applied to corporate bonds with greater efficacy. The clearing and settlement systems for equity instruments must be expanded to include bond instruments. Also, a separate system for bonds must be created. The Asian Bond Funds has successfully accelerated the integration of these two systems in some markets. Bangladesh can draw some valuable lessons from this practice.

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APPENDIX 1

Summary of Policy Issues and Recommendations

Equity Market

Policy Issues	Policy Recommendations
1. Smooth Operation in Primary market	1. Paying 20-25 per cent of the total money during application time and remaining amount within 10 days after allotment will ease the pressure on investors. 2. Holding draw should be ensured within three weeks and the whole process be completed within one month. 3. Increasing the number of bankers to the issuers including locations of bank branches and provision of accepting online application will ensure smooth participation of all types of investors. 4. Refund amount should not be delayed on the grounds that names are not properly written in issuer book or multiple BO accounts are maintained or several applications are made by a single investor. 5. Allegation that issuers in collaboration with banks delay the refund intentionally in order to reap undue pecuniary benefits through re-investment deserve thorough investigation and immediate remediation.

2. Margin Loan Ratio	1. The SEC may think of instituting a permanent policy for the margin ratio and let merchant banks lend investors within their own parameters. To this effect, 'maintenance margin' or 'credit balance' rule may be considered 2. Currently allowed capacity of NBFIs to hold maximum exposure (loan, own investments and commitment for underwriting) is required to be enhanced. They are not permitted to leverage more than five times of their paid-up capital.
3. Rumors	1. The SEC can notify investors immediately about the securities undergoing large deviations in terms of price and volume without sound justifications. 2. Merchant bankers and brokerage houses can organize regular awareness program for investors to help them make rational investment decisions and to warn them in advance against rumors to mitigate possible stock market over-reactions/under-reactions. 3. Merchant bankers and brokerage houses should stop comments about price hike of the shares without fundamental analysis.
4. Market Volatility	1. A comprehensive empirical research work on the efficacy of currently used mechanisms, trading halts and daily price limit in mitigating market volatility, is warranted. 2. Suitability of the mechanisms like margin regulations, price stabilization funds and securities transaction taxes merit proper

	attention of the policy markers.
5. Multiple BO Accounts	1. Meticulous examinations of required information in the BO accounts form namely, passport/voter ID number, driver license and bank statement are required to stop unscrupulous investors to open fictitious multiple BO accounts. 2. Many fake BO accounts opened at the initial stage of this provision should be detected and closed immediately. 3. No individual shall be allowed to use another investor's BO accounts for investment purpose.
6. Expansion of Issuer Base	1. More profitable state-owned enterprises, multinational corporations and large homegrown private enterprises with cleaner and stronger balance sheets should be listed with the SEC 2. Government can improve guidelines relating to capital structure of SOEs similar to those for financial institutions and banks. 3. Multinationals might be agreed during their registration time to go to public for capital after a certain period of operation in Bangladesh. 4. SMEs particularly export oriented garments industries should be encouraged to be listed under separate rules and regulations, as appropriate.
7. Fair Value of the Share	1. In addition to direct listing rules, book building system should be introduced

	quickly. Unnecessary formalities and transaction costs should also be cut down to improve market efficiency. 2. Local and foreign institutional as well as individual investors need to be enticed for fair price in the secondary market.
8. Incentives for Issuers	1. Less time-consuming compliances of numerous formalities, low cost of initial public equity offerings, tax free dividend income from PLC, elimination of double taxation, tax holiday and granting CIP status to the sponsors of PLC will be helpful to equity market improvement. 2. Shares with smallest denomination (say with paisa one/Tk. 1) like US penny stocks may be made available in the equity market. 3. Monitoring agencies, namely, SEC, DSE, CSE, CDBL and credit rating agencies need to play an integrated role in avoiding duplications of works of different agencies.
9. Advertisement	1. SEC should initiate awareness, educational and promotional programmes through institutional training and go for advertisement in domestic as well as foreign print and electronic media for a vibrant market with active presence of issuers and investors.
10. Foreign Portfolio Investments	1. Ensuring political stability, developing information infrastructure and making selective deregulations are required to entice foreign investors. 2. Image building activities through seminars, symposium and fairs at home and abroad

	deserve due considerations.
11. Securities and Exchange Commission	1. The SEC should protect investors' interest and create an enabling environment for issuers. For transparency in reporting financial results, the SEC may consider an Act similar to US Sarbanes-Oxley Act of 2002.
12. Brokerage Houses	1. Brokerage houses and their branches should extend services beyond metropolitan areas. 2. They should invest adequately in quality research. 3. Fixed brokerage commission rates need to be replaced by negotiable rates for trading of all sizes. 4. Allegations, such as, selling shares at high price without investors' consent and later replacing them by buying same number of shares at convenient times are required to be investigated
13. Stock Exchange	1. Stock exchange should shorten time-span for listing decision and improve capacity to deal with rising trade volume. 2. SME platform may be created in current structure of stock exchanges with separate rules and regulations for registration, listing and delisting. Perhaps, separate trading time may be required as well.
14. Registrar of Joint Stock Company and Firms (RJSCF)	1. RJSCF should be more prompt in registering issuers with specific deadlines. 2. Issues of side payment, harassments during registration and delayed clearance by

	RJSCF call for immediate resolutions

Corporate Bond Market

Policy Issues	Policy Recommendations
1.Government Initiatives	1. The government may take initiatives to issue treasury bonds with a few buckets of maturities extending to at least 10-year for constructing a benchmark yield curve 2. Government infrastructure projects and state-owned enterprises may be persuaded for mobilizing direct debt financing through bond issuance. 3. Government may encourage institutional investors to invest in corporate bonds with good rating.
2. Innovative Financial Products	1. Introduction of bonds like Treasury Inflation – Protected securities (TIPS), SUKUK Bond, High – Yield Bonds (HYB) and Deep Discount Bonds may also help laying out of corporate bond market architecture in Bangladesh.
3. Market	1. Private placement market may be encouraged at the initial stage to entice issuers. Marketability of securities considered as a drawback of private placements. This needs to be addressed with due attention. 2. Public placement market should also be there for issuers. Appropriate fiscal incentives and regulatory framework will be helpful in this regard. Introduction of Shelf Registration rules may be considered. 3. An Over-the-Counter (OTC) market that is

	extensively used for corporate bond trading should be established as a secondary market.
4. Knowledge-Based Trading	1. Banks and financial institutions that already have PD licenses must be activated at least for government bond market at the initial stage. Subsequently, PDs will use knowledge-based trading techniques acquire from government bond market for the corporate sector.
5. Statutory Restrictions on the Issuers and Captive Demand	1. A policy framework is required to be developed for SOEs in issuing bonds. 2. A joint cell of the BB and the SEC can allow banks and financial institutions to issue bonds in lieu of dual approval process 3. To mitigate banks' and financial institutions' captive demand for securities, BB can approve corporate bonds for SLR on the basis of credit rating.
6. Interest Rate and Cost of Bank Finance	1. Coordination is necessary among government, regulatory authorities and banks to create level playing fields in determining interest rates. 2. Banks manage to lend at lower rates whereas corporate issuers need to pay more interest to bond investors. In this case, loan-default culture, and interest waiver provision should be rescinded.
7. Credit Rating Agencies	1. More credit rating agencies are required to start their functions. 2. Regulatory authorities in Bangladesh can designate rating agencies in line with Nationally Recognized Statistical Rating Organization

	(NRSRO) of the USA on the basis of agencies' organizational structure, financial independence, quality of staff, rating procedures and internal procedures in processing private information.
8. Trustee	1. Apart from strengthening the capacity of the existing trustee, commercial banks (either local or foreign) may be permitted to have a separate professional trust department for public debt issues. 2. The SEC and the Bangladesh Bank may act as watchdogs to ensure that bond indenture clearly delineates the rights and the privileges of the bond holders with no potential conflicts of interest among investors, trustee, and issuers. 3. 3. The trustee should act judiciously in initiating possible legal actions against the issuers for their wrong doings.
9.Bond Clearing and Settlement Systems	1. Delivery versus Payment (DVP) systems introduced for government bonds should also apply to corporate bonds with greater efficacy. 2. The clearing and settlement systems for equity instruments must be expanded to include bond instruments. The Asian Bond Funds has successfully accelerated the integration of these two systems in some markets. Bangladesh can draw some valuable lessons from this practice.

APPENDIX 2

Corporate Debt Securities, 1994-2008*

BDT in Million

Year	Name of Issuer	Types of instruments	Amount	Total Amount
1994	Estern Housing	Debenture	900	1320
	Beximco Fisheries	Debenture	120	
	Beximco knitting	Debenture	300	
1995	BEXIMCO Textile	Debenture	240	700
	Beximco Denim	Debenture	300	
	BDZipper Ind. Ltd	Debenture	40	
	G.Q Textile Mills LTD	Debenture	120	
1996	Bangladesh Language Ind td.	Debenture	150	300
	Sonali Pulps and Newsprint	Debenture	150	
1998	Aramit Cement Ltd.	Debenture	112.5	366
	Karim Alumni Ltd.	Debenture	212.5	
	Green Arrow Tannery Ltd.	Debenture	15	
	Rangpur Foundry Ltd.	Debenture	20	
	Sino- Bangla Ind. Ltd.	Debenture	6	
1999	Bangladesh Welding Electrodes Ltd.	Debenture	20	20
2000	Nil	Nil		Nil
2001	IDLC Bangladesh Ltd	Debenture	100	150
	DLC Bangladesh Ltd	Debenture	25	
	United Leasing Co Ltd.	Debenture	25	
2002	IDLC Bangladesh Ltd.	Debenture	80	
	United Leasing Co Ltd.	Debenture	60	

Year	Name of Issuer	Types of instruments	Amount	Total Amount
	Industrial and Infrastructure Development Co Ltd.	Zero – Coupon Bond	1000	1255
	GPS Finance Company (BD) Ltd.	Non-Convertible Debenture	25	
	IDLC of Bangladesh Ltd.	Debenture	90	
2003	Premier Leasing International Ltd.	Debenture	100	2785
	GPS Finance Company (BD) Ltd.	Debenture	25	
	Dutch- Bangladesh Bank Ltd.	Debenture	500	
	IDLC of Bangladesh Ltd	Debenture	160	
	Delta–Brac Housing Finance Corporation Ltd.	Zero – Coupon Bond	1000	
	GPS Finance Company Ltd.	Debenture	150	
	IDLC of Bangladesh Ltd	Zero – Coupon Bond	250	
	United Leasing Co Ltd	Debenture	100	
	Prime Finance and Investment Ltd.	Bond	500	
2004	United Leasing Co Ltd	Debenture	300	988.58
	United Leasing Co Ltd	Debenture	30	
	IPDC of Bangladesh Ltd.	Zero – Coupon Bond	358.58	
	Prime Finance and Investment Ltd.	Bond	300	
2005	Belhasa-Accom and Associates Ltd.	Asset based security	10320	

Year	Name of Issuer	Types of instruments	Amount	Total Amount
	IDLC of Bangladesh Ltd	Debenture	200	BDT 12165
	Dhaka Bank Ltd.	Subordinated convertible bond	1000	
	Peoples Leasing and Financial services Ltd	Bond	300	
	Uttara Finance and	Bond	300	
	North Bengal Cycle Industries ltd.	Debenture	45	
2006	Hotel Sarina Ltd.	Debenture	37.5	BDT 1602.25 & US $180
	Sagor Konna Resort Ltd.	Debenture	10	
	Hotel Sky Palace Ltd	Debenture	30	
	BRAC	Asset based security	US$180	
	Bengal Fine Ceramic	Debenture	25	
	IBBL	Mudaraba Perpetual bond	1500	
2007	IDLC of Bangladesh Ltd	Asset based security	275	BDT 24619
	DBHFC	Zero coupon bond	1944	
	Malancha Holdings Ltd.	Zero coupon bond	22400	
2008	Ava Renewable Energy Ltd.	Debenture	30	BDT 10868
	IDLC Bangladesh Ltd	Zero coupon bond	1000	
	Bangladesh Industrial Finance Co Ltd.	Zero coupon bond	2000	
	.IDLC Bangladesh Ltd	Debenture	200	
	Goldenson Ltd	Debenture	30	
	Uttara Finance and Investment Ltd.	Zero coupon bond	2000	

Year	Name of Issuer	Types of instruments	Amount	Total Amount
	Promising Consortium Ltd.	Debenture	30	
	Echo Cotton Mills Ltd.	Debenture	40	
	United Leasing Company Ltd.	Zero coupon bond	1288	
	Grameen Phone Ltd.	Unsecured Bond	4250	

Note: Data of corporate bond and debenture in Appendix have been collected on calendar year basis where as those of Table 12 have been collected on financial year basis.

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Economic Research Group
9/4, Lalmatia, Block:D, Dhaka-1207
Phone: 880 2 9135966
Email: info@ergonline.org
Web: www.ergonline.org