INTERNSHIP REPORT
On
Financial Market Development and Challenges in Bangladesh

Submitted To:	**Submitted By:**
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A Dissertation Submitted in Fulfillment

of the Requirements of the Degree of

MASTAR'S OF BUSINESS ADMINISTRATION

Major in Finance

Of

HAJEE MOHAMMAD DANESH SCIENCE & TECHNOLOGY UNIVERSITY

DINAJPUR – 5200

October, 2016

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Chapter 1

Introduction

1.0 Introduction

Financial market has been playing an increasingly important role in the development of Bangladesh. There are many segments of financial market including money market, stock market, bond market, insurance market, foreign exchange market and derivatives market, etc. However, money moves from one segment to another segment of the financial market due mostly to the relative rates of return in different segments. Banks play a major role in the financial market of Bangladesh. The capital market is now the second largest segment of financial system. Investment in the saving instruments issued by National Saving Directorate (NSD) is the third largest segment of the financial market of the country.

The objective of this paper is to focus on the development of the financial market in Bangladesh and identify the challenges for the Bangladesh's financial system. The paper tries to determine the co-integrating relationship between the different segments of financial markets development & challenges in Bangladesh.

1.1 Objectives of the report

The major objectives of this report are:

- To explain the existing scenario of financial market in Bangladesh.
- To explore the challenges of financial market development in Bangladesh.
- To identify and analyze the major impediments, and recommend for financial market development.
- To examine the various issues in the Bangladeshi financial market and future prospects of this market.

1.2 Scope of the study

This study has analyzed the role of money market, capital market, bond market, insurance market and macroeconomic factors affecting the financial market. Some of the officials from BSEC, stock exchanges, market participants related to bond market have been discussed to understand the opportunities and impediments of financial market development in Bangladesh. The study has mainly concentrated on the financial development of Bangladesh Government Treasury Bond (BGTB) and the corporate bond market. The report has focused on the data of the FY 2015-16 published in the reports of Ministry of Finance (MOF), Bangladesh Bank (BB), Bangladesh Securities and Exchange Commission (BSEC), and

Dhaka Stock exchange Ltd. Data available in the internet on the financial markets in different countries has also been studied to prepare this report.

1.3 Problem Statement of Financial Market

Financial market is not easily tradable in Bangladesh. The problems of the capital markets in Bangladesh are structural, and actually quite far-reaching than what meets the eye. The capital markets notably the Dhaka Stock Exchange (DSE) is way overvalued due to, firstly, the DSE index calculations being incorrect. Secondly, there are big syndicates acting together to artificially influence the prices resulting in huge profits for them at the expense of the average investors who put in their hard earned lifetime savings. And last, is the Securities and Exchange Commission (SEC) whose total policy and regulations favor's the syndicates which primarily consist of high net worth people and the stock exchange members resulting in an "artificial demand driven market", until and unless these fundamental issues are addressed the capital markets. So, the issues individually like the DSE Index, the syndicates, comprising of stock exchange members and the SEC we can find the common link, which is the stock exchanges and the SEC. In Bangladesh the secondary bond market and insurance market are not active. This report has tried to find out the major opportunities and impediments in financial market development and suggested the remedial to be taken for the development of financial market.

1.4 Methodology of the Study

This report contains information gathered from secondary sources. Most of the information was collected from different web sites, some economic journals. A series discussion and conversation with the members and officials of the Dhaka Stock Exchange Ltd., some teaching professionals of Finance Department of Hajee Mohammad Danesh Science and Technology University as well as a few expertises's such as Md. Rony Kumar Datta, Ayrin Sultana, Shahnaz Parvin and Md. Jahangir Alam in the capital market also provides some information about the derivatives. Practical work exposures at different departments and relevant file study in the Bangladesh Bank, IMF, BSEC, Dhaka Stock Exchange Ltd. also provided strong base platform for preparing this report. Secondarily, various books and articles regarding derivatives have been used in designing the report format.

1.5 Why I'm interested to choose this topic?

It is a great pleasure and honor for me to say that Bangladesh become middle income country in 2021. Bangladesh has maintained an impressive track record on growth and development. Bangladesh aspires to be a middle-income country by 2021 in 50th anniversary of independences. This will require increasing GDP growth to 7.5 to 8 percent per year based on accelerated export and remittance growth. Both public and private investment will need to increase as well. Growth will also need to be more inclusive through creation of opportunities in the domestic financial markets. To sustain accelerated and inclusive growth, Bangladesh will need to manage the financial markets development more effectively, as well as prepare for challenges to face.

Bank-based finance has a special role to play for many companies in need of funds, and thus helps to ensure a well-balanced growth process. The economic literature on "relationship banking" has demonstrated that banks can contribute to alleviating the impact of sudden economic shocks on their clients. Banks stand ready to provide many customers with funds even in adverse circumstances, e.g. **when the liquidity of financial markets dries up.**

Nowadays, the lack of a well-developed stock market would be a particularly serious disadvantage for any developing country’s economy. Equity is essential for the emergence and growth of innovative firms. Today's young innovative high-technology firms will be the main drivers of future structural change essential for maintaining a country's long-term growth potential. The contribution of financial markets in this area is a necessity for maintaining the competitiveness of an economy today given the strongly increased international competition, rapid technological progress and the increased role of innovation for financial market.

1.6 Future Prospect of Financial Market Development

Against the backdrop of the global economic slowdown, the Bangladesh economy has performed strongly over the past few years. Despite the fallout from the Euro debt crisis still contributing to an uncertain environment, the Bangladesh economy has pursued accommodative monetary and fiscal policies. However, if the global economic slowdown is much more prolonged than the current forecasts indicate, the impact on Bangladesh is expected to be adverse. The economy has persevered so far in the face of global recession, but the domestic challenges are manifold with respect to soaring inflation, import-export imbalances, devaluation of the currency, a slow growth of remittances, increasing budget deficit and government borrowing.

The government borrowing has increased significantly even by historical standards - this could manifest itself in various problems for the economy. First, the increased borrowing may force up interest rates and crowd out private sector investment in Bangladesh. Second, if this borrowing trend continues, the government may need to increase the tax burden in the long-run. In addition to a dampening of demand and economic growth, this decision will be deeply unpopular. Finally, the increase in national debt would mean that the annual interest payments will raise - money that could have been spent in priority areas of the economy.

Financial markets have several economizing features, however, that help to overcome the limitations inherent in saving and investing that arise in the absence of financial institutions.
As we shall see, financial markets confer social benefits by extending the division of knowledge (really an extension of the division of labor), shifting capital into the hands of those most capable of investing it, helping reduce uncertainty inherent in human action which is future-oriented, and provide liquidity to investors who possess shorter time horizons.

Financial markets provide greater **liquidity** to individuals who desire it, and in so doing, allow for investment in projects with a wider variety of time horizons until completion. Without financial markets, only individuals with extremely low time preferences would be able to make any loans at all. If there is no secondary market in which to sell the claim to the loan, the lender is essentially "stuck" into the time horizon of the investment project.

Financial markets help us deal with the **uncertainty** that is inherent in investable projects (note that all human action is speculative because the future is uncertain). Ceteris paribus, individuals prefer less risk than more risk for a given return.

1.7 Financial Market Development in Bangladesh

The Bangladesh economy is within the mainstream of the continuously changing global financial system. Domestic as well as international trade also characterizes Bangladesh economy. Hence a financial system has developed here consisting mainly of the capital and the money market. For any underdevelopment country the existence of a well functioning money market is of paramount importance. The money market currently existing has also developed due to certain needs. In general, these needs can be termed as need for short term liquidity within our financial system, to carry out the day to day economic activities and obviously to meet and match need for short term lending and borrowing of the participants within the financial system. T-bill market is by far the largest component of the money market in Bangladesh. Capital markets are essentially about matching the needs of investors with those that need capital for development. Bangladesh has no shortage of both such parties, a young and dynamic population that increasingly wants, and is able to, make provision for lifetime events, to save for children's education, for the possibility of ill health and ultimately for old age and retirement. On the other side of the equation, Bangladesh has a pressing need for investment resources to bolster its stretched infrastructure resources, to build more power stations, bridges, ports and gas- pipelines to empower the people in the development of enterprise and the creation of jobs. Debt markets are an extremely effective mechanism for matching the long term needs of savers with those of entrepreneurs. Like emerging market countries around the world, Bangladesh could benefit from having a local-currency, fixed income securities market. At present, its main fixed income financial products are bank deposits, bank loans, government savings certificates, term loans, treasury bills, and government bonds and corporate debt (syndicated loans, private placement, and debentures). But in general the corporate debt market is still very small compared with the equity market.

1.8 Financial Market

A financial market is a market in which people trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural products.

In economics, typically, the term market means the aggregate of possible buyers and sellers of a certain good or service and the transactions between them.

The term "market" is sometimes used for what are more strictly exchanges, organizations that facilitate the trade in financial securities, e.g., a stock exchange or commodity exchange. This may be a physical location (like the NYSE, BSE, NSE) or an electronic system (like NASDAQ). Much trading of stocks takes place on an exchange; still, corporate actions (merger, spinoff) are outside an exchange, while any two companies or people, for whatever reason, may agree to sell stock from the one to the other without using an exchange.

Trading of currencies and bonds is largely on a bilateral basis, although some bonds trade on a stock exchange, and people are building electronic systems for these as well, similar to stock exchanges.

1.8.1 The Financial Market in Bangladesh is mainly of following types:

1. **Money Market**: The money market comprises banks and financial institutions as intermediaries, 20 of them are primary dealers in treasury securities. Interbank clean and repo based lending, BB's repo, reverse repo auctions, BB bills auctions, treasury bills auctions are primary operations in the money market, there is also active secondary trade in treasury bills (up to 1 year maturity).

2. **Taka Treasury Bond market:** The Taka Treasury bond market consists of primary issues of treasury bonds of different maturities (2, 5, 10, 15 and 20 years), and secondary trade therein through primary dealers. 20 banks performing as Primary Dealers participate directly in the primary auctions. Other bank and non bank investors can participate in primary auctions and in secondary trading through their nominated Primary Dealers. Non-resident individual and institutional investors can also participate in primary and secondary market, but only in treasury bonds. Monthly data on primary and secondary trade volumes in treasury bills and bonds and data on outstanding volume of treasury bonds held by non residents can be accessed at Monthly data of Treasury Bills & Bonds.

3. **Capital Market**: The primary issues and secondary trading of equity securities of capital market take place through two (02) stock exchanges-Dhaka Stock Exchange and Chittagong Stock Exchange. The instruments in these exchanges are equity securities (shares), debentures and corporate bonds. The capital market is regulated by Bangladesh Securities and Exchange Commission (BSEC).

4. **Foreign Exchange Market**: Towards liberalization of foreign exchange transactions, a number of measures were adopted since 1990s. Bangladeshi currency, the taka, was

declared convertible on current account transactions (as on 24 March 1994), in terms of Article VIII of IMF Article of Agreement (1994). As Taka is not convertible in capital account, resident owned capital is not freely transferable abroad. Repatriation of profits or disinvestment proceeds on non-resident FDI and portfolio investment inflows are permitted freely. Direct investments of non-residents in the industrial sector and portfolio investments of non-residents through stock exchanges are repatriable abroad, as also are capital gains and profits/dividends thereon. Investment abroad of resident-owned capital is subject to prior Bangladesh Bank approval, which is allowed only sparingly. Bangladesh adopted Floating Exchange Rate regime since 31 May 2003. Under the regime, BB does not interfere in the determination of exchange rate, but operates the monetary policy prudently for minimizing extreme swings in exchange rate to avoid adverse repercussion on the domestic economy. The exchange rate is being determined in the market on the basis of market demand and supply forces of the respective currencies. In the forex market banks are free to buy and sale foreign currency in the spot and also in the forward markets. However, to avoid any unusual volatility in the exchange rate, Bangladesh Bank, the regulator of foreign exchange market remains vigilant over the developments in the foreign exchange market and intervenes by buying and selling foreign currencies whenever it deems necessary to maintain stability in the foreign exchange market.

1.8.2 Functions of Financial Market Development

- **Intermediary functions:** The intermediary functions of financial markets include the following:
  - **Transfer of resources:** Financial markets facilitate the transfer of real economic resources from lenders to ultimate borrowers.
  - **Enhancing income:** Financial markets allow lenders to earn interest or dividend on their surplus invisible funds, thus contributing to the enhancement of the individual and the national income.
  - **Productive usage:** Financial markets allow for the productive use of the funds borrowed. The enhancing the income and the gross national production.
  - **Capital formation:** Financial markets provide a channel through which new savings flow to aid capital formation of a country.
  - **Price determination:** Financial markets allow for the determination of price of the traded financial assets through the interaction of buyers and sellers. They provide a sign for the allocation of funds in the economy based on the demand and to the supply through the mechanism called price discovery process.
  - **Sale mechanism:** Financial markets provide a mechanism for selling of a financial asset by an investor so as to offer the benefit of marketability and liquidity of such assets.
  - **Information:** The activities of the participants in the financial market result in the generation and the consequent dissemination of information to the various segments of the market. So as to reduce the cost of transaction of financial assets.

- **Financial Functions**
  - Providing the borrower with funds so as to enable them to carry out their investment plans.
  - Providing the lenders with earning assets so as to enable them to earn wealth by deploying the assets in production debentures.
  - Providing liquidity in the market so as to facilitate trading of funds.
  - Providing liquidity to commercial bank
  - Facilitating credit creation
  - Promoting savings
  - Promoting investment
  - Facilitating balanced economic growth
  - Improving trading floors

1.8.3 Components of Financial Market Development

Based on market levels

- **Primary market:** Primary market is a market for new issues or new financial claims. Hence it's also called new issue market. The primary market deals with those securities which are issued to the public for the first time.

- **Secondary market:** It's a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the stock exchange and it provides a continuous and regular market for buying and selling of securities.

Simply put, primary market is the market where the newly started company issued shares to the public for the first time through IPO (initial public offering). Secondary market is the market where the second hand securities are sold (security Commodity Markets).

Based on security types

- **Money market:** Money market is a market for dealing with financial assets and securities which have a maturity period of up to one year. In other words, it's a market for purely short term funds.
- **Capital market:** A capital market is a market for financial assets which have a long or indefinite maturity. Generally it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into: (a) industrial securities market (b) Govt. securities market and (c) long term loans market.
  - **Equity markets:** A market where ownership of securities are issued and subscribed is known as equity market. An example of a secondary equity market for shares is the Dhaka stock exchange.
  - **Debt market:** The market where funds are borrowed and lent is known as debt market. Arrangements are made in such a way that the borrowers agree to pay the lender the original amount of the loan plus some specified amount of interest.

- **Derivative markets:** A market where financial instruments are derived and traded based on an underlying asset such as commodities or stocks.
- **Financial service market:** A market that comprises participants such as commercial banks that provide various financial services like ATM. Credit cards. Credit rating, stock broking etc. is known as financial service market. Individuals and firms use financial services markets, to purchase services that enhance the working of debt and equity markets.
- **Depository markets:** A depository market consists of depository institutions that accept deposit from individuals and firms and uses these funds to participate in the debt market, by giving loans or purchasing other debt instruments such as treasure bills.
- **Non-depository market:** Non-depository market carry out various functions in financial markets ranging from financial intermediary to selling, insurance etc. The various constituencies in non-depositary markets are mutual funds, insurance companies, pension funds, brokerage firms etc.

1.9 Literature Review

According to Baele et. al (2004), the definition of an integrated financial market is a market for a defined set of financial instruments if all the potential market participants, with the same relevant characteristics, (1) face a single set of rules when they decide to deal with those financial instruments and/or services; (2) have equal access to the above-mentioned set of financial instruments and/or services; and (3) are treated equally when they are active in the market.

This definition of financial integration contains three important features:

First, it is independent of all the financial structures within the region. These financial structures cover issues like defining the scope of all financial intermediaries and importantly the dynamics and interplay between these financial intermediaries with regard to the flow of funds from households, corporate entities and the government.

Second, friction in the process of intermediation i.e. access to capital either through institutions or markets can persist after financial integration is completed. This implies that the essential objective behind financial integration is not removing these frictions, which hampers the optimal allocation of capital, but rather is concerned with the symmetric and asymmetric effects of such frictions on different areas. Thus, even in the presence of such frictions, several areas may be considered integrated as long as these frictions come to affect symmetrically (Baele et al., 2004).

Third, according to the definition advocated by Baele et al. (2004), the constituents of the financial market can be cleaved in two parts - being the supply of and the demand for investment opportunities. Accordingly, full integration entails the same access to banks or trading, clearing and settlement platforms for both investors (demand for investment opportunities) and firms (supply of investment opportunities, e.g. listings), regardless of their region of origin. Furthermore, once access has been granted, full integration requires that no discrimination should exist among comparable market participants based solely on their location of origin (Baele et al., 2004).

According to the same authors, there are three benefits to be derived from financial integration: more opportunities for risk sharing and diversification; more and efficient allocation of capital among investment opportunities; and potential for higher growth. Accordingly, these three benefits are inter-related, as it has been shown earlier in literature that sharing risk across regions enhances specialization in production (Baele et al. 2004; Kalemli-Ozcan et al. 2001). Similarly financial integration should lead to an increase in fund flows for investment opportunities in specific regions as should be the case when financial integration helps facilitate the access to investment opportunities in those regions (Baele et al., 2004).

Hamilton et al. (2005) claimed that while deregulation and technological change have unleashed tremendous competitive forces on the global financial system in recent years, resulting in enormous growth and innovation in the provision of financial services, which in turn have provided substantial benefits to the wider economy by providing households and corporations a much wider menu of instruments with which to borrow. At the same time, the expansion of choice horizon as well as exposure to new risks has increased premium on high quality financial advice and knowledge.

In the context of the subcontinent, though, it may be said that there is a lot of scope for applicability of financial market integration. With respect to Bangladesh, the financial sector industry is highly fragmented, with limited degree of overlap between the formal, semi-formal and informal markets for credit, savings, insurance and various other non-bank financial services such as lease financing, mutual funds and mortgages (South Asian Network of Microfinance Initiatives, 1998). Accordingly, efficient market intermediation here is constrained by two crucial barriers- institutional and policy environment. The institutional rigidities in place serve to constrain the operating and implementing effectiveness while an almost obsolescent legal and regulatory framework also poses considerable barriers to market integration. Importantly asymmetry regarding knowledge of information may be cited as a crucial factor (South Asian Network of Microfinance Initiatives, 1998).

Using a derived methodology Mohsin and Qayyum in 2005 tested empirically for the degree of financial market integration in 5 countries of South Asia separately. In summary, the authors were able to rule out the null hypothesis of perfect capital mobility for all South Asian countries, while only during the 1990s there were evidence of some degree of capital mobility in Bangladesh and Nepal. According to the authors’ estimates, India possessed the lowest degree of financial integration, while Bangladesh fell in between other countries.

Bhoi and Dal (1998) also attempted a study of financial integration on an empirical basis for India, and found that several segments of the financial market had achieved operational efficiency. India's financial markets were getting increasingly integrated at the short-end of the market, such as, money market, credit market, government securities market since April 1993. However, capital market was least integrated with the rest of the financial sector (Bhoi and Dhal, 1998). Thus their study regarding convergence of key financial markets yielded only mixed results, since evidence for convergence was observed only for short term markets.

In another study, Jain and Bhanumurthy (2005) also looked into the issue of financial integration in India. According to the authors, there appeared to be a long run relationship, or convergence (as discovered by the authors in the form of cointegration) amongst the call money rate, exchange rate and London Inter-Bank Offered Rate (LIBOR), which implied presence of a common stochastic trend between domestic and foreign market returns, and it was seen to be strengthening over time. However, the authors also warned that the financial reform programme (in the form of modifying policy and institutional infrastructure), must go in tandem with financial integration to reap the rewards properly.

Jena (2002) examined the degree of market integration empirically and attempted to provide some evidence on the market integration in India. He found that while the reform process had helped to remove institutional bottlenecks to the free flow of capital across various segments of the financial market; this had not yet been translated into complete integration among them.

From the above studies it may be observed that the concept of integration of financial market has a wide range of dimensions- regional, domestic, international, etc. The paper will follow integration concept expressed in the studies by Jain and Bhanumurthy (2005) and Jena (2002) to examine integration of domestic financial market in Bangladesh.

1.10 Reason Gap

The reasons for financial market developing in Bangladesh are many but here are a few –

First and most importantly, in the case of Bangladesh, it is of rationalised governance. The corporate model of the exchange under demutualised structure will enable management to take actions that are in the best interests of customers and the exchange itself. With the separation of ownership and trading privileges, an exchange will achieve greater independence from its members with respect to its regulatory functions. There will be the requisite degree of transparency. Demutualised exchanges will be forced to account to their shareholders regarding the bottom line as well as corporate governance.

Secondly, there will be more investor participation. The new corporation will be more profit orientated due to shareholder accountability. Unlike a mutual structure where often only broker-dealers a maybe member, a demutualised exchange affords both institutional and retail investors the opportunity to become shareholders. A demutualised exchange will have greater flexibility to accommodate the needs of institutional investors as customers, and potentially, as owners.

Thirdly, it is the resources for capital investment. A competitive stock exchange must be able to respond quickly to global competitive forces and technological advances. With the capital raised from initial public offerings or private investment and a heightened awareness of accountability to stakeholders, a stock exchange should have both the incentive and the resources to invest in the competitiveness of its information systems. So to be competitive, products and services must not only be timely and cost effective, but also reliable.

Another part of the structural changes needs to be at the SEC of Bangladesh. The fundamental issue here is: what is the regulator doing to help minimise risk for the investors? The absolute minimum the SEC can ensure is to have risk minimising tools. As a first step they can introduce scrip netting facility, like financial netting currently allowed, which could be in the form of settlement of trades being T+0: T is for time and currently trades have a settlement period of T+3 which means that investors buying any stock will have to wait three days before he can sell out his position. Next, they can introduce short selling whereby the investors has the facility to short sell if he thinks the price of stocks would fall and then buyback. By introducing these facilities it will allow investors to minimize risk as and increase liquidity as well. The SEC should also have a good surveillance system in place to ensure fair play. The introduction of equity derivatives should also most definitely be taken into serious consideration to minimize risk, as there are no instruments to do so.

Finally, the government of Bangladesh, who oversees the SEC, needs to ensure that the SEC as an organization is run by more professional and credible people who has sound knowledge of the capital markets and its mechanisms. If that means hiring professionals from local or abroad and paying them attractive salaries then be it.

1.11 Reasons of Future Perspective

The capital markets in Asia are getting more and more focus with the growing corporatization of the Asian economies. Eastern Asia has progressed a lot with respect to attracting western companies to get listed in Asian bourses as well as supporting innovative instruments, and Southeast Asia is also coming up with India leading the way. Comparing the local market scenario with that of the rest of the region, Bangladesh is in pretty good shape as we have most of the infrastructure in place. Our market capitalization is relatively smaller and it currently stands at $9.3 billion, which is just over 13 percent of GDP. Higher liquidity is skewed towards a handful of scrips, while a stagnant situation exists for few less profitable issuers.

At present, the government is heavily focusing on developing a debt capital market. Such measures are certainly welcome as Bangladesh lacks a proper secondary market for bonds. The market is yet to support short-term capital requirements of corporations. Commercial Paper (CP) has not yet been tried primarily due to interest rate volatility and illiquid risk-free instruments that can be used as benchmark neither for short-term and hardly for long-term financing. It can, therefore, be said that we have a somewhat flat yield curve in Bangladesh at the moment.

Despite challenges of political turmoil during the beginning of 2016, prudent and timely policy interventions from the present Government and Bangladesh Bank (Central Bank of Bangladesh) have kept the economy and financial sector vibrant and stable. Cautious but growth supportive monetary policy stance has been able to contain inflation within low single digit level (6.2 percent in November 2016), which is moderate and reasonable for a growing developing economy like Bangladesh.

Besides performing its core responsibility of maintaining price stability and external sector viability, Bangladesh Bank has been contributing to the impressive development journey of Bangladesh through promoting a socially responsible inclusive green financing strategy alongside massive digitization in the country's financial sector. In recent years, Bangladesh Bank has brought about deeper engagement of the financial sector in the developmental role with a social responsibility driven financial inclusion initiatives. Bangladesh Bank has taken up comprehensive reform and upgradation of the county's financial market infrastructure, including setting up of a fully automated nationwide online clearing and settlement system, Bangladesh Real Time Gross Settlement (BDRTGS), customer interest protection centers, launching of mobile financial services (more than 29 million accounts), no frill accounts for the disadvantaged and students (more than 16 million accounts), mandatory credit for agriculture, MSMEs, renewable energy, and so forth. The financial inclusion drive is supported by advanced technology, which has drastically reduced costs, increased the outreach, and enabled new players to leapfrog constraints.

The performance of the Bangladesh economy is grounded on very inclusive and broad based nature of growth, which has already gained global attention. The goal is now to deepen, widen, and further improve the quality of inclusive financing programs to ensure environmentally sustainable economic development. The inclusive growth strategy of the present government and Bangladesh Bank's sustained motivation and innovative policy initiatives in promoting environmentally sustainable green financing are paying off well for the Bangladesh economy. Looking forward, the 7th Five Year Plan (FY2016 - FY2020) aspires to accelerate economic growth to 8 percent by the year 2020, which will be inclusive, pro-poor, and environmentally sustainable. The private sector will take the lead role in bringing in the additional growth.

All the government organs with the lead role of the private sector need to work hard to pace up the inclusive socioeconomic growth and development momentum. We, however, need to put more attention towards long term mobilization of savings, and quick completion of the infrastructure projects.

We are now looking forward to attaining the higher middle income country status by 2030 and to advanced economy status by the decade of 2040s. I am sure given strong leadership by our down to earth, Honorable Prime Minister and participation of our hard working entrepreneurs and ordinary people; we will certainly be able to achieve this dream.

Chapter 2

Structure of Financial System in Bangladesh

2. Overview

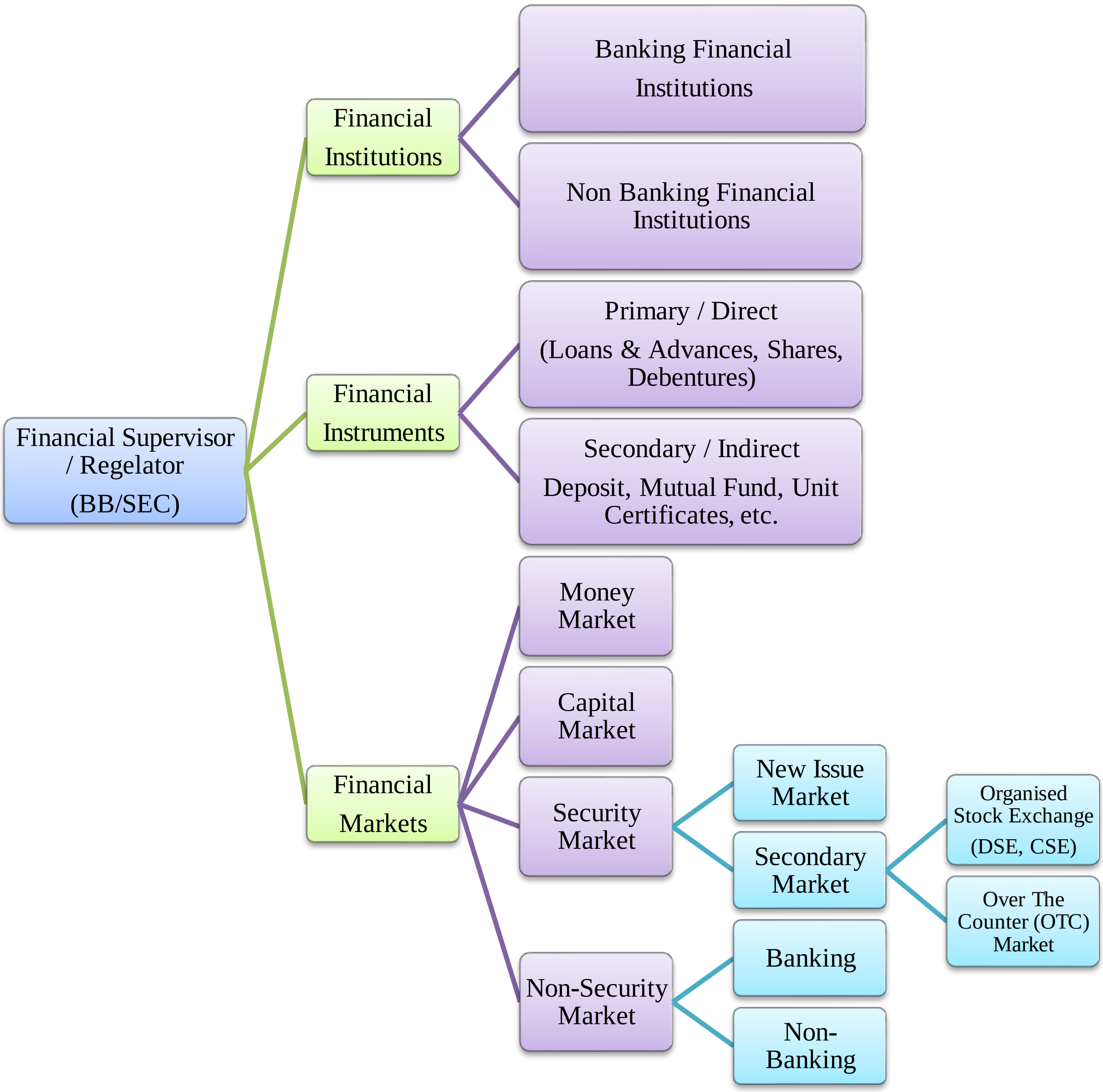
The financial system of Bangladesh consists of scheduled and non-scheduled banks, non-bank financial institutions, microfinance institutions, insurance companies, co-operative banks, merchant banks, brokerage houses, stock exchanges and credit rating companies. Different regulators are engaged to supervise those institutions. To ensure financial stability, which is a joint responsibility, data and information sharing among the regulators is taking place primarily through the coordination council chaired by the Governor of BB.

The financial system includes 5 state-owned commercial banks (SCBs), 3 specialized development banks (SDBs), 49 domestic private commercial banks (PCBs), 9 foreign commercial banks (FCBs), 4 Non-scheduled banks and 31 non-bank financial institutions (NBFIs). The financial system also embraces Investment Corporation of Bangladesh (ICB), Bangladesh House Building Finance Corporation (BHBFC), 2 stock exchanges [Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE)], 77 insurance companies, 697 registered micro-credit organizations, 55 merchant banks (investment banks), 8 credit rating companies, various depository participants (stock dealers, brokers, 17 asset management companies8 etc.) and registered co-operative banks.

The regulatory and supervisory arrangements for these entities are entry focused and well defined, with strong legal underpinnings. Bangladesh Bank (BB) regulates scheduled banks, Nonbank Financial Institutions (NBFIs), some operations of cooperative banks, merchant banking wings of commercial banks, etc. Bangladesh Securities and Exchange Commission (BSEC) mainly supervises the capital market. Merchant banks, brokerage houses, and asset management companies are also regulated by BSEC. Insurance companies and microfinance institutions are supervised by the Insurance Development and Regulatory Authority (IDRA) and the Micro-credit Regulatory Authority (MRA) respectively. Cooperatives and credit unions are governed by the Registrar of Cooperatives. There are some overlapping responsibilities in the supervision on institutions, as overlapping responsibilities sometimes arise due to functional regulations coexisting with legal-entity regulations. Beside the list of regulators mentioned earlier, the Ministry of Finance regulates the Bangladesh House Building Finance Corporation (BHBFC), Investment Corporation of Bangladesh (ICB), and has a supervisory network with other regulators.

A coordination council of the major financial sector regulators (BB, BSEC, IDRA, RJSC and MRA) meets regularly to share information and ideas with a view to better understand the financial system and to ensure early detection of systemic risk. As systemic risk may arise in any particular sector and spread to other sectors, it is very crucial to adopt a coordinated approach to supervision. Coordinated supervision allows avoidance of unnecessary duplication of work; decreases the risk of conflicting supervisory directives by the regulators; and increases the potential for synergies and alignment of related supervisory activities of the regulators. Taking these views into consideration, Bangladesh Bank has taken the initiative for coordinated supervision. It is expected that the financial sector will continuously evolve towards a more contemporary and efficient system with supportive investments, a friendly environment, and inclusive economic growth.

2.1 Structure of Financial System of Bangladesh



Financial Supervisor / Regelator (BB/SEC)
Financial Institutions
Banking Financial Institutions
Non Banking Financial Institutions
Financial Instruments
Primary / Direct (Loans & Advances, Shares, Debentures)
Secondary / Indirect Deposit, Mutual Fund, Unit Certificates, etc.
Financial Markets
Money Market
Capital Market
Security Market
New Issue Market
Secondary Market
Organised Stock Exchange (DSE, CSE)
Over The Counter (OTC) Market
Non-Security Market
Banking
Non-Banking

Chapter 3

Financial Market Development

3.1 Money Market

In recent years an increasing amount of attention has been devoted to the connection between financial markets and economic development. New insights in growth theory and the theory of finance establishing a link between "finance and growth" or "finance and development" have spurred interest in this topic, as has the appearance of a large number of empirical studies which have demonstrated a clear positive correlation between indicators providing a quantitative measure of activities of and on financial markets and quantitative indicators of the level of economic development. However, the positive connotation suggested by this literature represents only one side of the coin. The empirical evidence also shows that crisis-like developments in the financial markets have occurred with increasing frequency in recent years, and that such phenomena at least temporarily limit the scope for financial development. The Bangladesh financial crisis is the latest and most severe example. How can one explain the fact that a sector which can be regarded as being at least partially responsible for a successful course of financial market development is at the same time considered to be responsible at least for triggering crises which slow down economic development, often causing ground to be lost which it takes the economy years to regain?

This is a question for economic theory, and it is not the first time it has been asked, given that this dual impact of financial markets characterises the economic development of basically any country. Thus, after creating a uniform basis and standard for comparison using a flow-of-funds analysis, the following survey will seek to describe how economic theory has dealt, or is dealing, with the dual impact of financial markets on economic development. Four theories have been selected for consideration - neo-classical and Keynesian theory, the New Development Finance approach and the new theory of finance which is grounded in the economics of information. Each emphasises different aspects of the relationship between financial markets and economic development, but so far it has proved impossible to arrive at a consensus view. Accordingly, the role of financial markets in economic development is still a controversial issue - and with good reason, as is shown by the Asian example of smooth financial development and extraordinary growth (2000 - 2015), followed by a severe financial crisis (2016). This is why, in the concluding section, the question is turned around: Does the Asian example - seen against the background of this theoretical surveys - give an indication of the direction in which theoretical research should move if it wishes to better explain the dual impact of financial markets outlined above? The answer is a clear Yes, pointing to the need for a more detailed analysis of the monetary aspects of the relationship between financial markets and economic development and of financial development itself.

3.1.1 Recent Developments in the Banking Sector of Bangladesh

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

In order to counter these problems, the first round of financial sector reform was initiated in 1982 with the denationalization of some commercial banks, followed by the establishment of the National Commission on Money, Banking and Credit in 1984. However, major reforms in the sector were launched much later in the early 1990s.

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

Table 3.1: Assets of the Banking Sector as on June 2016

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

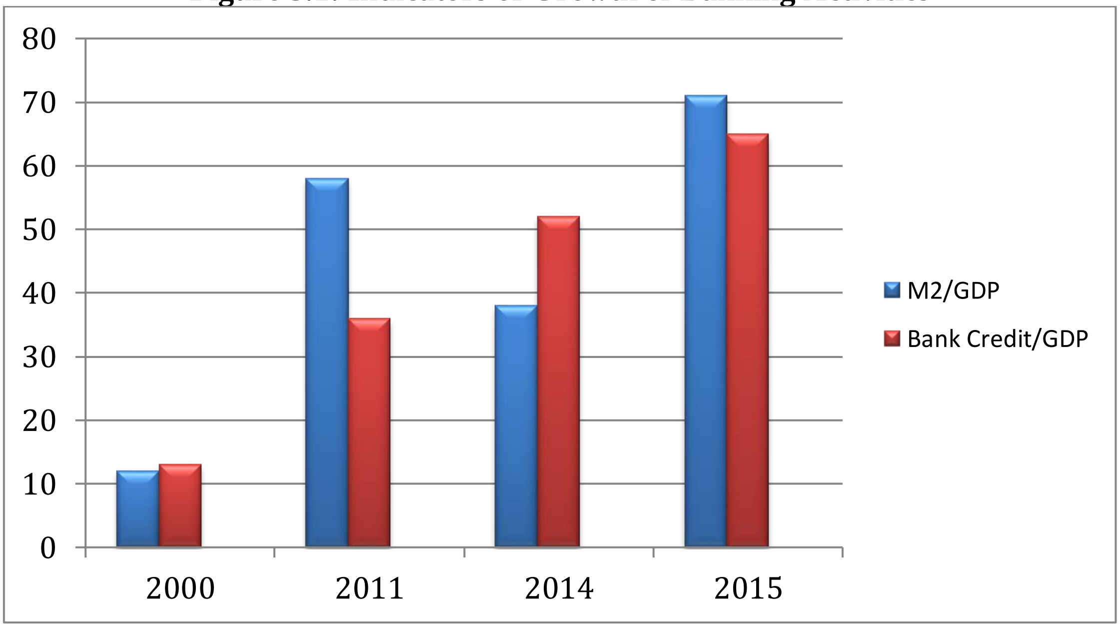
Recently the government granted licenses to 10 new private commercial banks in the early 2015 – 16. It was not till the mid-1980s that banks felt the strong compulsion to adopt reform measures. Once the weakness of the sector was identified, the government privatized three nationalized commercial banks during 1984-86 and granted licenses to four private commercial banks in the early 1980s. This round of reform, however, did not bring about the desired improvements and was considered largely unsuccessful due to regulatory and supervisory weaknesses of Bangladesh Bank, abusing of the banks' assets by the newly private managements/owners of the private commercial banks (PCBs) and NCBs' interest groups which resulted in a loan default culture.

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

3.1.2 Some Important Indicators of Banking Sector Performance

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

Figure 3.1: Indicators of Growth of Banking Activities



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

Table 3.2: Indicators of Banking Activities for selected countries (2015)

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

One of the most important indicators of the health of the banking sector is the Non-Performing Loan (NPL). Table 3.3 shows that there was a sharp decline in the share of non-performing loans (NPLs) from a high of 41% in 1999 to the lowest point of 6.1% in June 2011 but it has been on the rise ever since. What was a major positive development for the banking sector, was turned upside down by the banking scams. There are still some serious concerns about the portfolio quality of the public sector banks that are not properly reflected in the data. Both SCBs and PCBs recorded impressive improvements in terms of addressing the NPL problem. In particular, the NPL ratio of private banks declined to less than 3 percent in 2011, compared with more than 27% in 1999 but increasing to 5.7% in 2015.

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

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

Indicators	1999 (Pre-Reform Baseline)	2011 (the comparator best year)	2015 (Latest Available)
Share of Non-Performing Loans: Overall	41.1	6.12	10.75
Share of Non-Performing Loans: Private Banks	27.1	2.95	5.7
Share of Non-Performing Loans: Foreign Banks	3.8	2.96	6.19
Share of Non-Performing Loans: State Commercial Banks	45.6	11.27	23.23
Share of Non-Performing Loans: Public DFIs	65.0	25.55	33.12
Risk-weighted Capital Ratio: Overall	7.4	11.35	10.68
Risk-weighted Capital Ratio: Private Banks	11.0	11.49	12.05
Risk-weighted Capital Ratio: Foreign Banks	15.8	20.97	20.61
Risk-weighted Capital Ratio: State	5.3	11.68	8.65

Commercial Banks			
Risk-weighted Capital Ratio: Public DFIs	5.8	-4.49	-13.68

Profitability of banks measured against the rates of return on assets and equity had experienced a decrease, with the only exception being the foreign banks. Foreign banks have shown positive outcome in terms of profitability, with their return on assets increasing from 3.24% to 3.48% and return on equity increasing from 16.58% to 20.14% from 2011 to 2015 respectively. Table 3.4 shows the Return on assets and equity of the banks.

Table 3.4: Profitability of the Banking Sector (Percent)

Types of Banks	Return on Assets			Return on Equity		
	1999 (Pre-Reform Baseline)	2011 (the comparator best year)	2015*(Latest Available)	1999 (Pre-Reform Baseline)	2011 (the comparator best year)	2015*(Latest Available)
All Banks	0.2	1.54	0.61	5.24	17.02	8.36
Private Banks	0.8	1.59	0.78	15.32	15.69	8.4
Foreign Banks	3.5	3.24	3.48	41.84	16.58	20.14
State Commercial Banks	0	1.34	-0.09	-1.08	19.66	-2.35
Public DFIs	-1.6	0.03	-0.87	-29.4	-0.92	-9.46

Table 3.5: Performance Indicators of the Banking Sector in Selected Countries (2015)

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

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

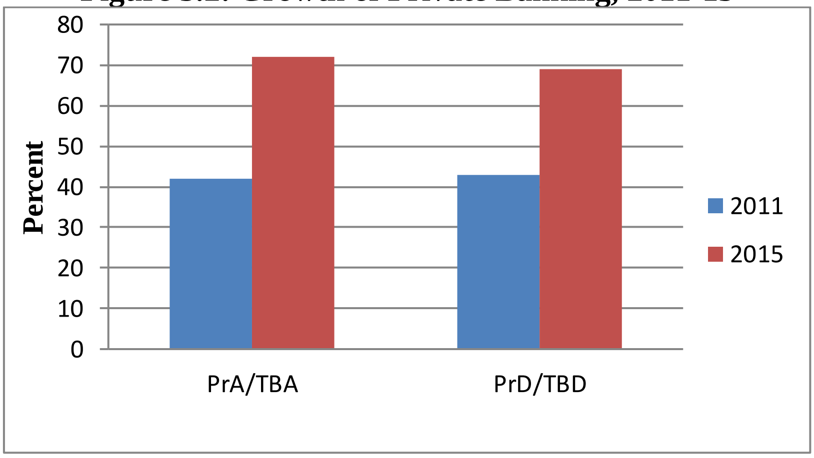
Table 3.6: Banking Sector Coverage Indicators for Selected Countries (2015)

Country	Number of Commercial Banks	Number of Commercial Bank Branches	Number of Automated Teller Machines (ATMs)

China	204	86708	519996
India	157	105933	115849
Pakistan	38	10943	7634
Vietnam	47	2497	15265
Bangladesh	56	8342	6797

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

Figure 3.2: Growth of Private Banking, 2011-15



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

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

3.1.3 Foreign Exchange Market

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

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

The FX derivative markets, such as futures, options, swaps, etc., are permitted for transaction. The FX market was extremely active in Bangladesh in recent years and almost 90 percent of inter-bank FX transactions were done in US dollar. The monthly average turnover of inter-bank FX transactions was USD 387.4 million in CY15, which was USD 448.2 million in CY14 and USD 223.4 million in CY13. The monthly average trade volume almost doubled in CY14, but decreased by 13.6 percent in CY15 compared with the preceding calendar year. Political turbulence during CY15 and associated economic slowdown probably contributed to the lower volume of trade in the FX market in CY15.

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

	CY13	CY14	CY15
Monthly average turnover of interbank FX transactions (USD million)	223.4	448.2	387.4

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

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

3.1.4 Recent Nominal and Real Effective Exchange Rate Movements

In its latest Monetary Policy Statement (January-June 2014), Bangladesh Bank (BB) aimed to preserve external sector stability, building up reserves and avoiding excessive volatility of the exchange rate. Improved external balances are reflected in the accumulation of international reserves of about USD2.8 billion during second half of FY14 with gross reserves increasing to US$21.6 billion at the end of June 2014, sufficient to cover more than six months of projected imports.

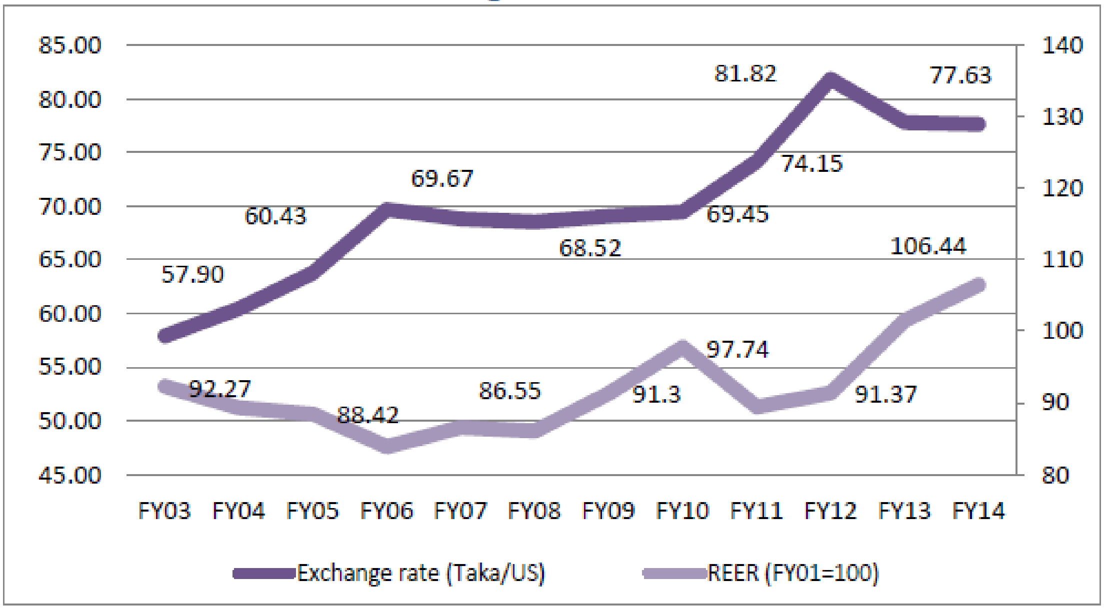
However, large surpluses in the external current accounts and the overall balance of the BOP in recent years have led to an oversupply of dollars in the foreign exchange market and the exchange rate would have appreciated significantly in nominal terms against the US dollar unless Bangladesh Bank continued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

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

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

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

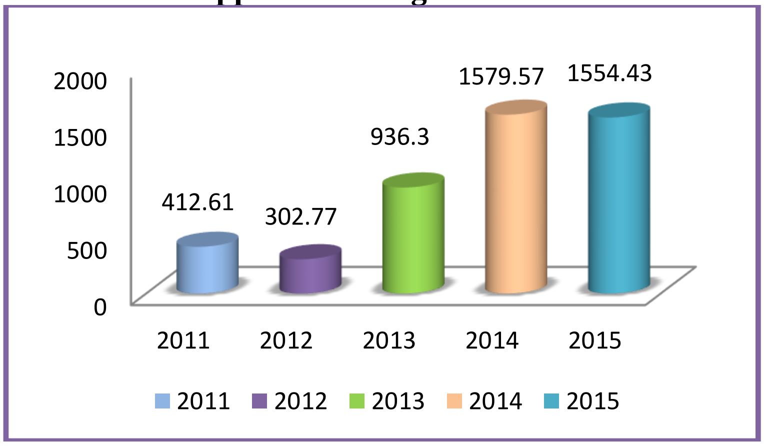
Figure 3.3: Nominal Exchange Rate and Real Effective Exchange Rate Trend of Bangladesh Taka



3.1.5 Foreign Currency Denominated Borrowing by the Domestic Private Sector

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

Figure 3.4: Total Approved Foreign Loan to the Private Sector



The total loan approved for private sector in Bangladesh has been increasing consistently from 2011 onwards. The total approved loan increased from $0.412 million in 2011, to $1.55 billion in 2015, which is an increase of 277%. From 2013 onwards, the approval process for loans has increased significantly which indicates that the central bank is actively trying to open up foreign financing sources for the private sector. A sectoral classification of the foreign loan portfolio of the private sector from 2011-2015 shows that the sector that received the highest amount was the telecommunication/ISP sector which accounted for 42.6% of the total. The second and third highest loan amounts was received by the Power and RMG/Related products sector, which accounted for 18.6% and 12.5% of the cumulative loans for the period. The highest recipient of foreign loans, the telecommunication/ISP sector, is exposed to relatively less risk due to most of them being parented by large international conglomerates. In comparison, most of the power sector and RMG sector projects are owned domestically.

Table 3.8: Sector-wise Distribution of approved loan (2011-2015)

	Number of Companies	Total Sector wise Approval (USD in millions)	Sector wise loan as % of Total
RMG/Related Products	98	693.7	12.5
Power	22	1028.8	18.6
Telecommunications/ISP	11	2356	42.6
Agriculture Products/Dairy Products/Food & Allied	11	127.2	2.3
Pharmaceuticals/Healthcare	8	140.5	2.5
Cement	7	85.5	1.5
Shipping, Water Transport. Cargo Handling	5	111	2.0
Packaging	4	6.2	0.1
Footwear	3	20	0.4
Electronic Goods Manufacturing	3	34	0.6
Air Transport	3	98.9	1.8
Steel	3	232.5	4.2
Conglomerate	1	365	6.6
Other	24	236.8	4.3
Total	**203**	**5536.1**	**100**

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

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

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

3.1.6 Recent Setbacks to the Banking Sector: Banking Scams and Default Loans

In three months from March 31, 2016 the total default loans of banks rose to Tk. 3,183 crore with the scam-hit BASIC Bank accounting for almost 64 percent of the rise. As of June 30, the banking sector’s total default loans stood at Tk. 51,345 crore, up 6.59 percent from the first quarter, according to Bangladesh Bank data. The amount is 10.75 percent of the total outstanding loans. The state-run BASIC Bank alone accounted for Tk 2,034 crore of the default loans, which was 40.77 percent of its total outstanding loans. Only ICB Islami Bank has a higher percentage of default loans.

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

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

Another reason behind the increase in default loans was that in 2014 and 2015 many loans were given through fraudulent practices, which are now gradually becoming defaults. Even though political tensions are somewhat stable now, businesses are still recovering and many are unable to repay their loans on time. The carryover of the losses incurred by investors in the stock market with borrowed funds (margin borrowing), which were not classified and provisioned against under special arrangements with Bangladesh Bank, is also adding to the amount of classified loans. Another reason for the rise in default loans of state-owned banks is the bad financial performance of jute sector enterprises, including public sector entities.

3.1.7 Microfinance

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

Table 3.9: Indicators of Microfinance Institutions

	June-12	June-13	June-14	June-15	June-16
No. of Licensed NGO-MFIs	421	518	580	618	694
No. of Employees	1,07,175	1,09,597	1,33,828	1,30,654	1,32,734
No. of clients (Million)	25.	25.	35.	33.	33
No. of Borrowers (Million)	19.	19.	29.	28.	28
Amount of Loan Outstanding (TK Billion)	143.	145.	246.	291.	341
Amount of Savings (TK Billion)	51.	51.	122.	192.	226.2

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

3.1.8 Financial Inclusiveness: The Growing Importance of Branchless Banking

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

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

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

By late 2015 and into 2016 two early leaders have emerged with the largest customer bases and agent networks, The bKash service and Dutch Bangla Mobile. The bKash service is provided by BRAC Bank in cooperation with its subsidiary bKash. And Dutch Bangla Mobile is a service from Dutch Bangla Bank. Combined, these two providers made the largest contribution to the nearly 500,000 new mobile accounts and more than 9,000 new agents. Such services are also provided by others like Trust Bank Ltd., Bank Asia, UCash service from United Commercial Bank Ltd., MyCash from Mercantile Bank Limited and the Fast Cash service from E-Cash Ltd.

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

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

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

Table 3.10: Indicators of Mobile Banking for Bangladesh (2014-2016)

Indicators	**2014**	**2015**	**2016**
Number of registered mobile money accounts	3,229,573	13,173,425	16,862,251
Number of active mobile money accounts	764,186	3,989,128	4,472,342
Number of registered agent outlets	5,654	54,594	185,023
Number of active agent outlets	2,551	45,183	136,333
Number of mobile money transactions (during the reference year)	229,592	25,895,678	228,601,768
Value of mobile money transactions (during the reference year) in Million Taka	476	63,809	516,648
Outstanding balances on active mobile money accounts in Million Taka	44	746	3,141

3.2 Capital Market

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

Exchange. The instruments in these exchanges are equity securities (shares), debentures, corporate bonds and treasury bonds. The capital market in Bangladesh is regulated by the Securities Exchange Commission (SEC) of Bangladesh.

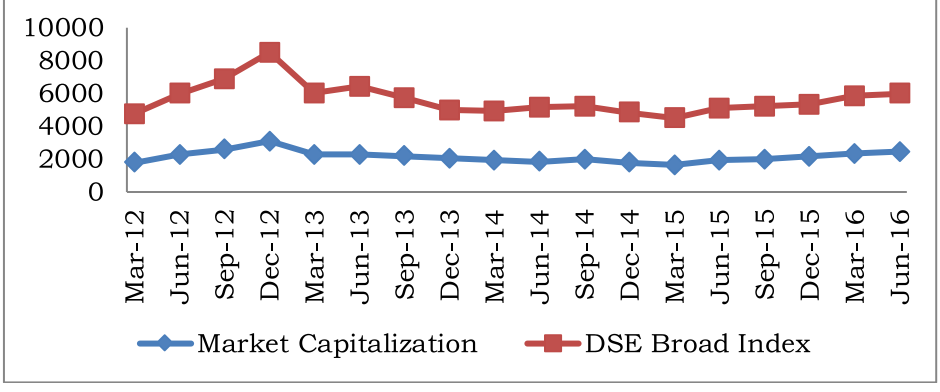
It has been observed that in recent years the capital market in Bangladesh has grown much faster than the other segments of the financial market. This growth in the capital market was initially (during 2007-2009) fueled by stronger economic fundamentals compared to valuation of stocks. Afterwards, speculative forces had taken various key market indicators like the market capitalization, price earnings ratio and market turnover to unprecedented levels. Table 4.1 shows some selected indicators of capital market developments referring to three choice of years, year 2007 representing the pre-bubble era, year 2010 representing the peak bubble year and finally 2016 showing the current year scenario. It can be observed that market capitalization and the DSE General price index increased dramatically in the peak year.

Table 3.11: Indicators of Capital Market Developments (DSE)

	FY 2007 (Pre-bubble year)	FY 2010 (Peak of the bubble)	FY 2016* (as of June 2016)
Number of listed securities	281	279	315
Issued equity and debt (billion Tk)	83.7	213.1	482.7
Market capitalization (billion Tk)	412.2	2277.0	2386.8
Turnover (billion Tk)	164.7	2714.3	1125.4
General Price Index	2149.3	6153.7	n/a
DSE Broad Index	n/a	n/a	4480
DSE -30 Index	n/a	n/a	1644.8

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

Figure 3.5: Market Capitalization and the DSE GEN Index



3.2.1 Developments in the Stock Markets

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

Figure 3.6: Market Capitalization as Percentage of GDP

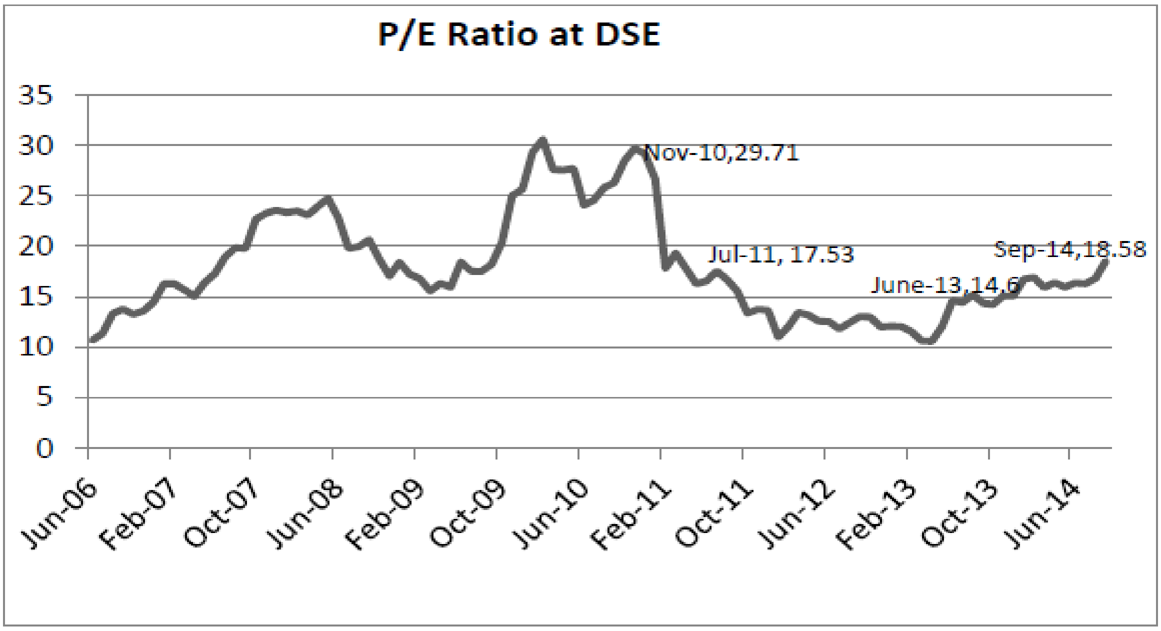
Market capitalization of the stock market reached 31.8% of the total financial sector in 2010, when the capital market passed through a bubble phase.

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

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

As regards valuation, certainly the current Price-Earning (P/E) Ratio at its recent low of 10.6 as of March 2013 was certainly much more attractive from investors' perspective compared with the average P/E Ratio of 30.6 at its recent peak in February 2010. It is certainly true that stocks traded in DSE have become much cheaper after the correction relative to their recent past peak levels. Accordingly, investors' interests returned and the stock prices in recent months have recovered significantly and the P/E ratio hit a three-year high of 15.1 toward the end of 2013. The P/E ratio has increased further in 2014 and reached 18.58% as of September 2014. Hikes in individual share prices as investors started to return and a decline in earnings by listed companies amid a prolonged political turmoil resulted in the rise in market P/E ratio.

Figure 3.7: P/E Ratio at DSE



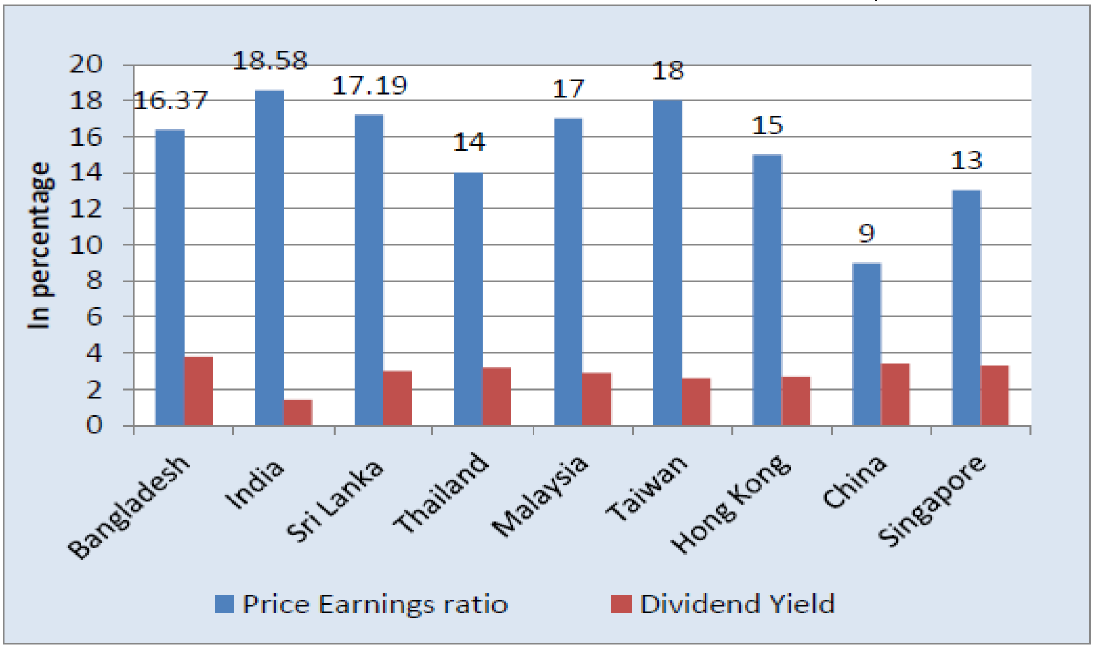
A review of DSE's past performance and a comparison with regional comparators indicates that:

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

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

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

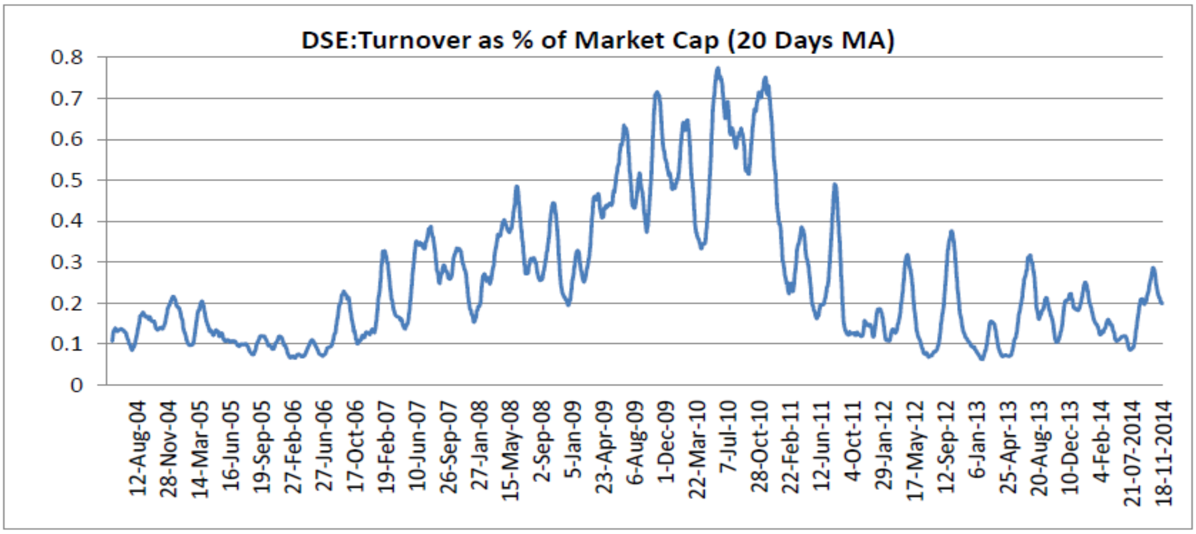
Figure 4.6: P/E Ratio as on June 2014



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

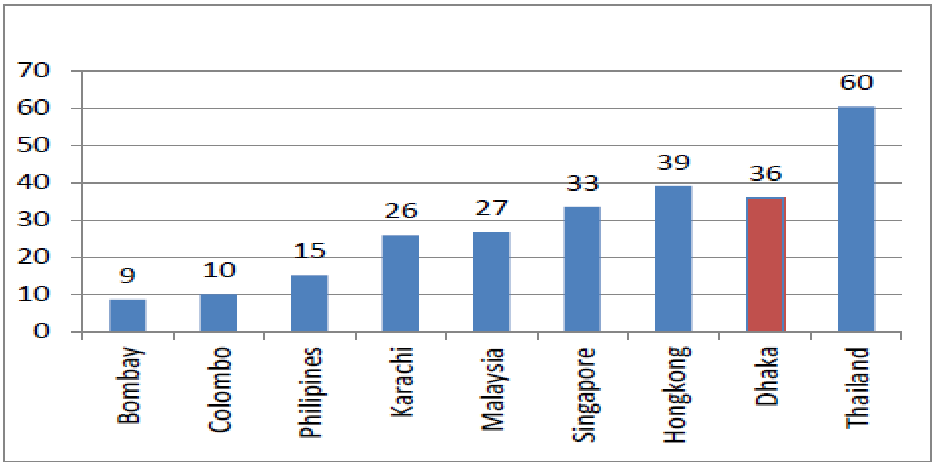
In order to filter the volatility in daily turnover due to various reasons we measured the 20-day moving average for DSE daily turnover as percent of market capitalization for a longer period. It is noteworthy that, despite smoothing out through the moving average method, the ratio has been quite volatile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

Figure 3.8: DSE Turnover as % of Market Cap (20 Days MA)



In addition to looking at the turnover to market capitalization ratio over time for Bangladesh, we also compared the annual market turnover as a percent of market capitalization for 2015 for a selected number of countries. Certainly for 2015, many months after the correction, the annual turnover ratio for DSE at 36 percent compared quite favorably with most of the regional comparators except for Thailand which is an outlier.

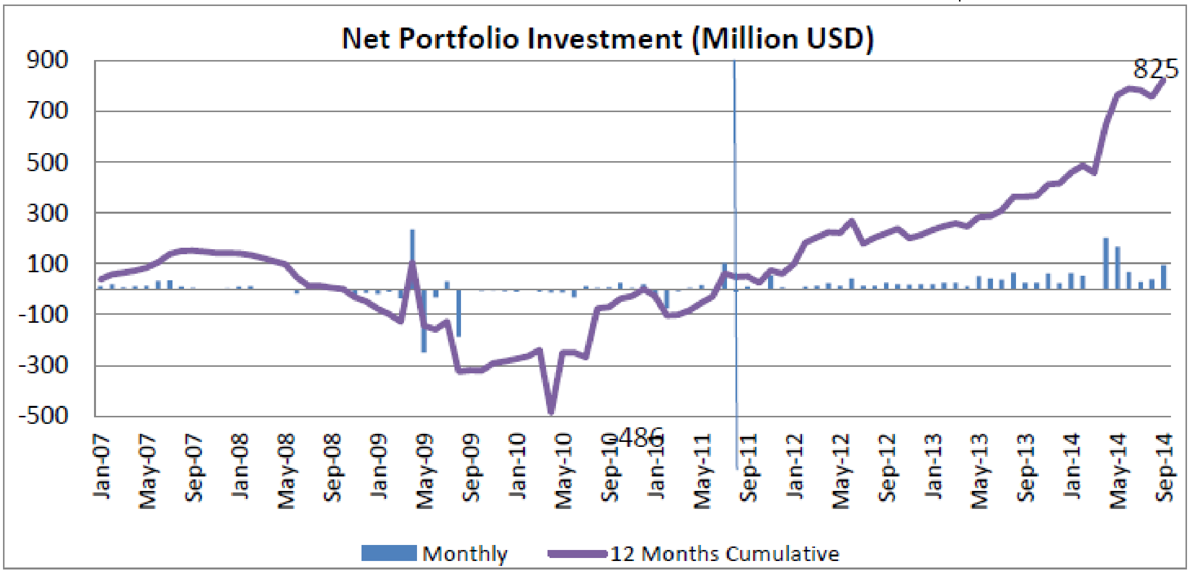
Figure 3.9: Turnover as % of Market Cap in 2015



3.2.3 Do We Observe a Sustained Recovery in the Bangladesh Market?

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

Figure 3.10: Net Portfolio Investment (Million USD)



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

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

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

3.2.4 Capital Market Activities in FY16

Primary Issuance

Sixteen companies raised new equity of Taka 8.84 billion in the capital market in FY14, lower than the Taka 12.58 billion raised by the seventeen companies in FY16. The volume of public offerings in FY16 was oversubscribed more than three times indicating a shortage of new securities in the primary market. Bonus shares worth of Taka 34.4 billion were issued in FY16 by one hundred and sixty one companies against retained profits. This was lower than Taka 43.0 billion issued in FY15 by one hundred and fifty seven companies.

Secondary Market Activities

As a percent of market capitalisation the financial sector dominated with 37.2 percent share, followed by services and miscellaneous (33.7 percent), manufacturing (28.8 percent) and corporate bonds (0.3 percent) at the end of June FY16. In Dhaka stock exchange (DSE), market capitalisation inclusive of new issues increased by 1.5 percent to Taka 2530.2 billion or 24.4 percent of GDP at the end of FY16 from Taka 2491.6 billion at the end of FY14. In Chittagong Stock Exchange (CSE), it grew by 2.6 percent to Taka 1919.9 billion or 18.5 percent of GDP at the end of FY16.

Non-Resident Portfolio Investment

Gross investment inflow in shares and securities of the stock exchanges by nonresidents through Non-resident Investor Taka Account (NITA) increased to Taka 18.0 billion in FY16 from Taka 15.7 billion in FY15. Gross outflow as repatriation of sale proceeds also increased to Taka 7.8 billion in FY16 from Taka 6.7 billion in FY15. From April 1992 to June 2016, the gross investment inflow stood at Taka 87.4 billion against gross outflow as repatriation of sale proceeds of Taka 75.1 billion.

3.2.5 Are Regulatory Reforms to Govern the Stock Markets Progressing Well?

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

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

- Limited SEC capability in areas of regulation, surveillance, and enforcement
- Limited financial stability oversight and policy coordination between SEC, Bangladesh Bank and the Ministry of Finance
- Weak regulation, governance and operation of stock exchanges

- Small institutional investor and mutual fund industry: underdeveloped insurance industry serving only 1%-2% of population; nascent mutual fund segment of the financial sector
- Limited supply of bonds and equities

The key recommendations were:

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

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

3.3 Bond Market

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

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

Table 3.12: Performance Indicators of Listed Securities at DSE as of September' 2016

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

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

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

3.3.1 Government Bonds

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

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

Commercial banks have an obligation to purchase government securities as it is accepted as a security to meet their Statutory Liquidity Requirement (SLR) under the Banking Companies Act. In December 2013, government issued 5 and 10 years maturity treasury bonds and in July 2007, launched bonds of 15 and 20 years of maturity. The capital raising pattern has been changed from a focus in treasury bills to a noteworthy increase in treasury bonds. The ratio of treasury bills to treasury bonds has changed from 20:80 in 2005 to 80:20 in 2011. The share of treasury bonds in total debt/savings instruments is gradually increasing whereas that of NSD certificates is declining. As of June 2016, 46% and 34% of total government securities were of treasury bonds and NSD certificates respectively (Table 3.15).

Table 3.13: Outstanding Stock of Treasury Bills, Bonds and NSD Certificates (In Billion Taka)

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
T-bills							
91-day	68.5	65.5	85.5	102	114	115	99
182-day	67	75	83.5	90.6	103	114.5	117
364 day	106.5	126	145.5	161.3	185.8	193.8	215.8
2-year	0	0	0	0	0	0	0
5-year	0	0	0	0	0	0	0
BGTB							
2-year				21	36	49	63
5-year	248.7	258.5	274.1	279	283.5	290	301.2
10-year	325.9	346.9	364.9	373.9	383.8	395.3	404.7
15-year	104.4	107.4	113.4	117.9	122.4	128.9	140.4
20-year	86.1	89.1	92.1	96.6	101.1	107.1	117.1
Sub Total	1007	1068.4	1165	1242.2	1329.6	1393.6	1458.2
NSD Certificates	640.9	646.1	645.1	666.1	683.7	719.7	764
Total	1648	1714.5	1810	1908.3	2013.3	2113.3	2222.2

Table 3.15: Percentage Share of Government Securities in Total Debt/Savings Instruments

Period	T-bills (91day, 182day, 364 day, 2 & 5year)	BGTB (2, 5, 10, 15 & 20 year)	NSD Certificates
Dec-12	8%	39%	54%
Dec-13	10%	43%	47%
Dec-14	15%	46%	39%
Dec-15	20%	46%	34%
Jun-16	19%	46%	34%

3.3.2 Corporate Bond

The corporate bond market in Bangladesh remains at a nascent stage, with a shallow debenture market. In 1987–2005 only 17 debentures were issued through public offerings. The eight debentures still outstanding in 2016 had an issue value of only $2 million. The corporate bond market faces important constraints—but also a potential for growth in bank and infrastructure bonds that could spark its development. There are only 3 corporate bonds currently operating in the country -- IBBL Mudaraba Perpetual Bond, ACI Zero Coupon Bond and BRAC Bank subordinated Bond.

Table 3.16: Corporate Bonds of Bangladesh

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

3.3.3 Constraints on the development of the Bond Market

The bond market of Bangladesh is very underdeveloped. A number of factors including supply side constraints such as a lack of benchmark bonds, inadequate regulatory system, market distortions due to national savings scheme, and a lack of interest from private companies in bond markets because of high costs, default of debentures in the past, and the general preference of investor in the equities rather than in bonds are responsible for the slow growth of the bond market in Bangladesh4. Although efforts are made by the government to issue benchmark bonds, they are not yet sufficient. Moreover, secondary market in the government securities is illiquid, which hampers the proper pricing of treasury bonds in the primary market.

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

In order to attract foreign institutional investors or large scale investments, Bangladesh needs to develop future markets for foreign exchange and interest rate risks since currency conversion rates would impact return on investment from interest income for long-term investments and eventual repatriation of capital. In emerging markets, over a ten year long lending horizon, without the ability to hedge against interest and exchange rates in the face of any unmitigated risks or crises in the financial system, investors will never invest large amounts of capital unless they are allowed to hedge a certain portion of that capital. Currently, there is no forward market for investments longer than 3 to 6 months. It is thus important that the financial sector is organized in such a manner that longer maturity hedging instruments are available for investors. With the availability of proper market based hedging instruments, the volume of foreign exchange trading can be increased significantly, thus also increasing the size of the capital market. Investors are more likely to hold trading portfolios if hedging against certain risks is available.

In this context, derivative instruments, which have emerged as an important feature of modern financial markets, can play a vital role in managing the risk of underlying securities such as bonds, equity, equity indexes, currency, short term interest rate asset, or liability positions. When hedge vehicles are used as primary instruments, they may become risky business. However, if used properly, derivatives are not likely to be more risky than the underlying assets from which these are derived. When used as hedge vehicles, derivatives can enhance returns and reduce risks. Similarly, short selling arrangement can also help the investors. Currently the market is structured in such a way that all foreign investments at the time of repatriation are guaranteed by the government at the taka-dollar exchange rate value initially agreed upon, as commonly practiced in the case of power sector and other infrastructure investments in Bangladesh. In this setting, the investors are essentially hedging all their investments, but the entirety of the risks lies upon the government. One option could be to transfer the risks onto the operators/investors instead of the government such that the government does not have to take any further risks. Under this arrangement, hedging through market rather than the government will reduce unmitigated risks for both government as well as the investors. Therefore, implementing risk management strategies in the financial sector should be a key priority on the agenda for the Seventh Five Year Plan. It is also important to caution that widespread introduction of derivatives to markets, in the absence of enabling legislation, accepted commercial conventions and risk control would also be imprudent.

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

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

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

A thorough review of institutional investment regulations should be undertaken as investment regulations are ad hoc in nature. Mistrust and structural deficiencies in these markets likely will keep institutional investors away until deep reforms are introduced. In this regard, several key elements of the bond market infrastructure would need to be addressed during the Seventh Plan. Some of these elements include: effective clearing and settlement system, conducive trading platform, standardization of accounting norms and uniform valuation of securities, observance of international best practices such as IOSCO principles in investor protection. Ensuring transparent markets and systemic risk reduction would contribute greatly towards strengthening the regulatory framework and encourage institutional investment in the bond market.
Inefficiencies in the taxation system (transaction taxes and high rates) have reduced the attractiveness of financial markets and encouraged tax evasion. The high transaction costs of bond issuance are impediments. Specifically, the registration fee, stamp duties, annual trustee fees on outstanding amounts, and ancillary charges exert to dampen the bond issue, albeit registration fees for debentures (bonds) have been reduced in recent years.

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

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

3.3.4 The issuance of Municipal Bonds

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

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

- A strong need for local infrastructure finance in Bangladesh, including for investments related to climate change adaptation. If financing can be raised through municipal bonds, it could be used to finance specific projects or broader investment plans.
- The Annual Development Programme (ADP) system suffers from delays in payment for infrastructure projects for years, and often causes projects to compete for funding on non-economic/political criteria. In this situation, a market-based system with investors helping decide whether the projects have economic worth would play useful role.

3.4 Insurance Market

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

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

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

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

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

Table 3.17: Performance Indicators of the Insurance Market

	2010	**2013**	**2016**
Number of Insurance Companies	62	62	66
Number of Insurance Policy Holders	3,246,108	6,703,073	17,098,364
of which: Life insurance policies	3,015,861	6,279,031	16,038,269
Non-life insurance policies	230,247	424,042	1,060,095
Number of Insurance Policies	7,689,907	15,114,084	17,968,616
of which: Life insurance policies	6,978,299	13,863,772	16,498,603
Non-life insurance policies	711,608	1,250,312	1,470,013
Insurance corporations	38,012	109,109	182,973
of which: Life insurance tech. reserves	32,641	100,985	172,050
Non-life insurance tech. reserves	5,371	8,124	10,923

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

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

Chapter 4

Challenges of Financial Market

4.1 Challenges and Concerns Relating to the Banking Sector

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

First, there are sharp differences in the performance of banks, especially between private and public banks. For example, the NPL of private banks in June 2016 was 5.7%, but it was 23% for public commercial banks and 33% for public specialized development banks. Furthermore, the reported NPL numbers likely understate the true portfolio quality problems in the public and private banks because they do not fully account for the effects of the recently discovered scams, the losses incurred by the merchant banks due to the bursting of the stock price bubble, the quality of regulatory standards are not as stringent as they should be, and the quality of accounting standards are also not up to the mark.

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

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

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

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

Sixth, the experience of the past few years has shown that the lack of autonomy of the Central Bank is particularly constraining in regards to the conduct of sound monetary policy and the granting of licenses for new banks. Monetary policy was overtly expansive during FY13-16 partly owing to pressures from the Government to pump liquidity in the stock market and the financing of Treasury operations. This led to considerable damage to underlying economic outcomes including the fueling of inflation, contributing to asset price bubble and putting pressure on the exchange market during those years. Similarly, undue Government pressure has forced Bangladesh Bank to issue several new licenses to new private banks at a time when most analysts believe new banks were not needed as they would tend to substitute the services provided by existing banks and contribute to solvency and/or profitability problems for existing banks.

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

4.2 Challenges Relating to the Capital Market

The first challenge in the capital market has been long overdue because there was too much money in the stock market in too few stocks. This inflationary pressure was finally controlled by the central bank by raising its cash reserve ratio (CRR) and statutory liquidity ratio (SLR) thus resulting in limiting the liquidity flow into the capital market. The interbank call money rate (DIBOR Dhaka Interbank Offer Rate) went up by 189 percent. One of the main reasons for this was that the domestic banks had too much of their money invested in the stock market, for quick and easy profit taking and as a result caused the stock market to rise even higher. So, to control the excess money in the capital market the central bank took these drastic measures, as it is within their right to do so, to control inflation.

The challenges of the capital markets in Bangladesh are structural, and, actually quite far-reaching than what meets the eye. As we all know, the capital markets here, notably the Dhaka Stock Exchange (DSE), is way overvalued due to, firstly, the DSE index calculations being incorrect. Secondly, there are big syndicates acting together to artificially influence the prices resulting in huge profits for them at the expense of the average investors who put in their hard earned lifetime savings. And last, but definitely not least, is the Securities and Exchange Commission (SEC) whose total policy and regulations favor's the syndicates which primarily consists of high net worth people and the stock exchange members resulting in an "artificial demand driven market". Until and unless these fundamental issues are addressed the capital markets here will fail to see the light of the day.

So, if we look at the issues individually like the DSE Index, the syndicates, comprising of stock exchange members and the SEC we can find the common link, which is the stock exchanges and the SEC.

4.3 Challenges Relating to the Bond Market

This study investigates the current status of bond markets of Bangladesh. The skinny bond market in Bangladesh faces multiple challenges like excessive dependence on bank credit, dominance of primary auction based government debt instruments, lack of product variation, and absence of benchmark yield curve. The prerequisites of the bond market development and factors to influence the bond market indicates that the neighbor countries have dramatically progressed in almost all the categories while Bangladesh does not meet most of the preconditions to develop an efficient bond market. It is believed that Bangladesh will be able to accelerate its momentum in the bond market if she adopts all viable strategies, experiences and reforms program of developed bond markets.

4.4 Challenges Relating to the Insurance Market

The Insurance Market is plagued by its various challenges. **First,** there is less public awareness regarding insurance services among the vast majority of people living in rural areas who are as a result left outside the insurance coverage. People in general are not aware of the benefits from the insurance policy in Bangladesh. **Second,** most of the insurance companies in our country are located in urban areas and there are few branches in rural areas. They do not realize that majority of the population reside in rural areas and if branches are expanded to rural areas, then the business can thrive there subject to adoption of a policy to motivate the mass people in the rural areas to raise their awareness. **Third,** the growing cost of business is a hindrance that insurance companies are facing nowadays. The rate at which tax, house rents, utility bills, commission fees and the costs of stationeries are rising exceeds the rate at which their business is growing. Besides, the policy holders are not willing to pay too much premium with the increasing costs of living that is hampering the strategies of insurance companies. Other challenges include the limited range of insurance services provided, lack of qualified officials, the very archaic methods of premium calculations adopted by the companies, the lack of training for employees, the limited use of information technology, insufficient service and the lack of marketing policy. The managements are not taking initiatives to increase their market penetration. They allocate tiny amounts of money for the advertisement purpose, which is not sufficient for increasing business development.

Chapter 5

Findings, Recommendations And Conclusion

5.1 Findings

- The financial system remains under stress and capital market activities have been weak. Several financial scams and resultant loan defaults in the state-owned commercial banks (SCBs) moved them into a position of insolvency. Capital market activities remained generally weak throughout FY16.

- During the end of last fiscal year, we have seen huge gap between GDP target and actual achievement, declining inflation rate, increasing export, growing foreign exchange reserve, declining subsidy requirement, high interest government deficit financing, declining foreign direct investment, declining private sector investment, increasing default rate, increasing liquidity and some ADP targets achievement.

- Credit flow from banking sector has not increased as expected in the current fiscal year. We have recently seen high default culture in banking sector as around BDT 426 billion of bank money is stuck up in court cases now. Non Performing Loan has augmented due to less governance, supervision as well as more window dressing of classified loans through rescheduling. Besides, in the current fiscal year we have not seen any significant structural reform in banking sector however we have found some small initiatives from Bangladesh Bank to introduce new product lines.

- Ensuring Capital Adequacy Ratio of 10% has become challenging for few banks where BASEL III will require to ensure Capital Adequacy Ratio of 12.5% including additional 2.5% of RWA as Capital Conservation Buffer. Traditionally, 85% of the income of bank comes from interest on loan. Interest rate of banking sector is comparatively quite low now as a whole but it seems burden for the small investors yet. The Government and Bangladesh Bank together are trying to cut bank interest rate to 9% or below from the existing effective interest rate of 18% to 22%. The highest interest rate paid by Financial Institutions is 10% and the spread is around 5% to 7%. The reasons for high spread are high operating cost, financial depression, lack of adequate competition, market power of few large dominant banks, high inflation rate, high risk premium due to high risk of most borrowers, burden of Non-Performing Loan, limitations in using Open Market Operation etc. High interest rate spread increases the likelihood of NPLs. It causes inflation increasing cost of production or cost of goods sold. Opening Back to Back L/C and machinery import have increased to support investment. Private commercial banks are the major market share holders in trade facilitation. They have contributed over four -fifths of export proceeds and three-fourths of import payments during current fiscal year. PCBs also dominate as a major market share holders in trade financing, remittance services and maintaining foreign currency accounts.

- Private sector investment has declined mainly due to lack of confidence in entrepreneurs. Agricultural credit is steady, investment in manufacturing is low and machinery import has increased but not being reflected in investment. Large tern loan disbursement has increased but small loan disbursement is low which is risky for the banking sector. Infrastructure development is also required for creating favorable environment of private investment.

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

- Money markets provide another foundation for bond markets. The money markets in Bangladesh are quite small. There is an interbank market, in which commercial banks borrow and lend to adjust their short positions. Normal maturities range from overnight to 30 days. Bangladesh also has a forward market for US dollars against taka, but only for short maturities. There is no commercial paper market.

- As government is the single biggest borrower in the domestic market, rates offered by different government instruments determine interest rates of commercial banks and corporate debt issues. Having the same level of risk, yield of the treasury bills and bonds at different maturities are comparatively much lower than that of the other instrument specially savings certificates. The violation of this fundamental norm impedes the enhancement of the bond market.

- The capacity and flexibility of Bangladesh Bank to supervise the banking industry and implement prudential measures are often constrained. Owing to lack of autonomy, Bangladesh Bank often cannot withstand political pressure that compromises prudential management. Similarly its operational flexibility is inadequate.

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

- The mobile financial services market is at an early stage of development as providers are working to improve their technology build agent networks and acquire new customers. This involves finding and training agents, marketing, helping customers transact and acquiring customers by using know-your-customer (KYC) and account opening processes.

- Stock Exchanges act as the clearinghouse for each transaction, meaning that they collect and deliver the shares, and guarantee payment to the seller of a security. This eliminates the risk of an individual buyer or seller that the counterparty could default on the transaction. In principle, the stock market accelerates economic development and growth by providing a boost to domestic savings and increasing the quantity and the quality of investment. The stock market encourages savings by providing individuals with an additional financial instrument. The better savings mobilization may stimulate and increase the savings rate significantly and improve the economy.

- According to the IMF report on the stock markets in the underdeveloped and developing countries in Africa and Asia, stock markets are getting setback often due to the inefficiency, lack of knowledge and expertise in stock market operations. Stock market provides capital flow in the economy thus increases investment opportunities and creates employment opportunities, that is, it meets the top priorities of any government's strategy and planning. Stock market of any country needs proactive supports from the government, statutory bodies, central bank and stock trading houses. The government can support by its prudent and efficient Fiscal Policy, the central bank can support by its monetary policy and others by taking timely and corrective steps to improve the stock market.

- Bangladesh is a country that suffers from immense social, political, economic and environmental factors, and these issues need to be addressed for the overall development of the country. However, economic development is one of the prime areas, which can resolve many of the country's current problems. The growth of businesses in the market economies has created great opportunities for Bangladesh in furthering development.

- Mutual fund (MF) is a very useful investment mechanism in a capital market. A developed capital market consists of varieties of investment instruments and MF is one of them. But the share of mutual funds in Bangladesh's capital market is very low. The market is fully equity-based and there is little scope to introduce any new financial instrument. That's why a rapid development has not happened in the MF sector all. But MF can be a good investment alternative in this undiversified market.

- Investment friendly environment and favourable political environment to generate medium and long term investors' confidence are extremely required for ensuring high GDP growth rate. The main road block of ensuring high GDP growth rate is the steady private investment at this moment however we have some favourable economic indicators. Besides, lack of adequate reform in power generation and supply, land availability, communication system and corruption are also responsible for steady private investment.

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

5.2 Recommendations

5.2.1 Recommendations for the Reform of the Banking Sector

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

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

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

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

Such lending restrictions are akin to a “dual banking system” with “narrow banks” that are likely to remain state-owned (and only allowed to gather deposits to invest in government paper) and conventional private sector banks. No new laws are required because the government as owners of the public banks could take this decision. The idea of narrow bank is not a new one and merits serious attention2. At the least the Government might ask Bangladesh Bank to review this option carefully and provide a technical proposal. The

Government must understand that it faces a very tight fiscal situation owing to the burden of energy subsidies and it cannot absorb yet another fiscal shock from a potential liquidity crisis in public banks emerging from an overload of infected portfolio. The government has already spent or allocated Tk. 95 billion during FY14 and FY15 for recapitalization of public sector banks and much more resources wil be needed in the coming years only to fill the huge wholes already identified or created (buy yet to be publicly identified) in the balance sheet of public banks.

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

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

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

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

5.2.2 Recommendations for Capital Market Developments and Policy

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

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

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

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

5.2.3 Recommendations for Governance and Operations of Primary

and Secondary Markets and Self Regulatory Organizations

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

5.2.4 Recommendations for Derivatives and Securitization Markets

- The development of a legal and regulatory foundation to accommodate derivatives, by amending the company's act; banking and non-bank financial institutions acts; trust and bankruptcy acts; introduction of specialized derivatives legislation that provides the legal basis for derivative contracts, netting, etc.

- It is recommended that the authorities and market participants begin developing risk management systems to identify measure, monitor and control various risks.

- The authorities and market participants should begin a dialogue on the structure of a future derivatives industry. For instance, if derivatives will be: exchange traded and/or OTC traded; and whether to establish a CCP.

- To concentrate liquidity in a few derivative instruments, it is recommended that contracts be created in:
  - interest rate derivatives (forwards or swaps in the 91-day Treasury bill and 5-year bond);
  - foreign exchange forward or currency swap (one month or three month Dollar/Taka pair);
  - a general stock index derivative initially aimed at institutional investors (an OTC index forward or swap, exchange-traded index future and option on future); and

- As Securitization is information-intensive and requires enhanced disclosure and trading, the authorities and market participants should:
    - encourage the establishment or strengthen credit and property registries;
    - publish secondary market and OTC price and volume data (by industry associations); encourage the establishment of pricing vendors;
    - (industry participants should) join international industry groups and SRO's; and
    - Observe IOSCO's Code of Conduct for rating agencies.

5.2.5 Recommendations for the Legal/Regulatory Framework

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

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

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

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

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

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

5.2.6 Recommendations for Government and Corporate Bonds

- The deepening of the government bond market through creation of large benchmark issues, re-openings and other techniques. The Debt Management Office should be strengthened so that the Ministry of Finance (MOF) can issue bonds at market rates.

- Asset backed securitization of debt provides a potentially important source of fund and reduces funding costs for investors and for the financial intermediaries by addressing the problem of asset-liability mismatches. Government has many projects like Jamuna Bridge and other roads and flyovers from which tolls are collected. If the income streams of these assets are securitized through issuance of asset backed securities/bonds, the bond market will get strong support.

- Secondary market trading should be encouraged by making trading of government bonds by primary dealers easier and allowing all government bonds to be accepted as collateral by the central bank.

- Development of organized futures market will help promote market liquidity and efficient pricing in the secondary market. In this context, derivatives which have emerged as an important feature of modern financial markets can play a vital role in managing the risks of underlying securities such as bonds, equity, currency exchange risk and interest rate risks.

- Facilitating private issuance of corporate bonds through the formation of a private placement and clarification of regulations of corporate bonds.

- Creating market awareness of corporate bonds.

5.2.7 Recommendations for the Development of Municipal Bonds

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

- Blending of debt and grant funds will allow the effective interest rates to be lowered for municipal projects.
- As financial market intermediaries are not very familiar with municipal bonds, awareness needs to be built and the intermediaries would have to be educated.

- Credit rating agencies can develop ratings criteria and carry out evaluations of local government finances.
- Pilot municipal bonds can be floated in the short run with support from development partners and the government for development of systems and procedures.

- Competition between donor funds and market financing needs to be eliminated when the latter is more appropriate or else there will be no economic incentive for market financing, as donor funding will always be cheaper.
- It will be necessary to consult with the potential investors of the bond, and to familiarize them with the sector.

- The Bangladesh Mutual Development Fund (BMDF) could be a good candidate to provide market access for urban local bodies (city corporations and municipalities), by using a pooled financing or other intermediary arrangement and should be evaluated by the GOB.

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

5.2.8 Recommendations for Insurance Market

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

i. agreeing to a timetable for recapitalizing all the insurance companies in accordance with Insurance Act 2010;
ii. adopting investment regulations as required by Section 41 of the Insurance Act 2010;
iii. initiating implementation of this white paper; and
iv. Implementation of the following regulations: (a) management of IDRA Fund and (b) CEO appointment.

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

5.3 Conclusion Observations

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

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

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

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

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

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

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

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

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

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

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

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Letter of Transmittal

October, 2016

To,

Md. Mostafizur Rahman
Assistant Professor
Department of Management
Faculty of Business Studies
HSTU, Dinajpur - 5200

Subject: Submission of Internship report.

Dear Sir,
With due respect, I submit herewith the internship report titled "Financial Market Development & Challenges in Bangladesh" prepared by me as a part of BBA program to you for your sympathetic consideration.

In this report, an endeavor has been made to make the report as informative as possible within the given time limit. There, however, remain some inadequacies in the report due to non availabilities of data/information.

I sincerely expect that you would be kind enough to accept my report for evaluation and oblige thereby.

Thanking you for your kind supervision.

Sincerely yours,

(Md. Sohel Chowdhury)
ID. No. E140503042
3rd Batch, MBA(Evening)
Faculty of Business Studies
HSTU, Dinajpur - 5200

Declaration

I do solemnly declare that this thesis report submitted in partial requirements for the Master's of Business Administration (Evening) specialized in Finance under Faculty of Business Studies of Hajee Mohammad Danesh Science & Technology University; is the result of my own research work and written in my own language. That no part of the report consists of materials copied or plagiarized or unpublished work of other writers and that all materials borrowed or reproduced from other published or unpublished sources have either been put under quotation or due acknowledgement with full reference in appropriate place(s). I understand that the MBA (Evening) conferred on me may be cancelled/ withdrawn if subsequently it is discovered that the report is not my original work and that it contains materials copied/ plagiarized or borrowed without proper acknowledgement.

Name of Participant : Md. Sohel Chowdhury

ID. No. : E140503042

Signature : ~~~~~~~~~~~~~~~~~~~~

<u>**Name & Signature of guide/ Supervisor**</u>

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(Md. Mostafizur Rahman)

Assistant Professor

Department of Management

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Supervisor's Declaration

I declare that the concerned thesis report entitled "Financial Market Development and Challenges in Bangladesh" is submitted by Md. Sohel Chowdhury, Student ID. No. E140503042, MBA (Evening), Major in Finance, Session: May – 2014 completed his thesis report under my Supervision and submitted for the partial fulfillment of the requirement of the degree of Master's of Business Administration (Evening) at Hajee Mohammad Danesh Science & Technology University, Dinajpur – 5200.
~~~~~~~~~~~~~~~~~~~~~~~~~~

I wish him every success in life.

~~~~~~~~~~~~~~~~~~~~~~~~~~~

(Md. Mostafizur Rahman)
Assistant Professor
Department of Management
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Co-supervisor's Declaration
~~~~~~~~~~~~~~~~~~~~~~~~~~~

I declare that the concerned thesis report entitled “Financial Market Development and Challenges in Bangladesh” is submitted by Md. Sohel Chowdhury, Student ID. No. E140503042, MBA (Evening), Major in Finance, Session: May – 2014 completed his thesis report under my Co-supervision and submitted for the partial fulfillment of the requirement of the degree of Master’s of Business Administration (Evening) at Hajee Mohammad Danesh Science & Technology University, Dinajpur – 5200.

I wish him every success in life.

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Abbreviations

ADB	Asian Development Bank
SFYP	Sixth Five Year Plan
NSD	National Savings Directorate
DFI	Development Financial Institutions

NBFI	Non Bank Financial Institutions
MFI	Microfinance Institutions
SOCB	State Owned Commercial Banks
FCB	Foreign Commercial Banks
PCB	Private Commercial Banks
DSE	Dhaka Stock Exchange
PKSF	Palli Karma Shahayak Foundation
NPL	Non Performing Loans
FSRP	Financial Sector Reform Project
WB	The World Bank
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
IMF	International Monetary Fund
FSI	Financial Soundness Indicators
FAS	Financial Access Survey
GDP	Gross Domestic Product
QIS	Quantitative Impact Study
CAR	Capital Adequacy Ratio
MCR	Minimum Capital Requirement
MPS	Monetary Policy Statement
BOP	Balance of Payments
CPI	Consumer Price Index
ECF	Extended Credit Facility
FDI	Foreign Direct Investment

REER	Real Effective Exchange Rate
LC	Letter of Credit
MRA	Microcredit Regulatory Authority
NGO	Non Government Organizations
IDRA	Insurance Development and Regulatory Authority
KYC	Know-your-customer
IPO	Initial Public Offering
CAMD	Capital Adequacy and Market Discipline
ROE	Return on Equity
ROA	Return on Assets
SEC	Securities Exchange Commission
ICB	Investment Corporation of Bangladesh
CDS	Central Depository System
CDBL	Central Depository Bangladesh Limited
MA	Moving Average
CSE	Chittagong Stock Exchange
BCA	Banking Control Act
FRA	Financial Regulatory Act
MOF	Ministry of Finance
PD	Primary Dealers
SRO	Self-Regulatory Organizations
IAS	International Accounting Standards
DVP	Delivery versus Payment
CCP	Central Counter Party

OTC	Over the Counter
MOU	Memorandum of Understanding
BGTB	Bangladesh Government Treasury Bonds
SLR	Statutory Liquidity Requirement
CDMC	Cash and Debt Management Committee
PSDU	Pension Sector Development Unit
UNCDF	United Nations Capital Development Fund