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Prospects and Challenges of Bond Market Development in Bangladesh*

Abstract

The thin bond market in Bangladesh faces manifold challenges emanating from several sources including excessive reliance on bank credit, government debt instruments dominated by primary auction based activity, absence of benchmark yield curve, and lack of product variation. The situation calls for well prioritized policies and actions in several areas. Reduction in interest on government savings instruments and registration fees, tax exemption on interest income of bonds/debentures, rating of bond instruments by independent rating agency prior to issue are some measures that can be implemented without delay. Other policies proposed for implementation include: raising a part of debt through issue of marketable bonds for public utilities and infrastructure projects and debt securitization for existing ones, development of institutional investors, better corporate governance and improved disclosure and transparency in business transactions to create confidence of investors and issuers alike.

* This note has been prepared by Md. Akhtaruzzaman (SRE), Md. Habibur Rahman (SRE) and Md. Habibour Rahman (RE) of the PAU.

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Prospects and Challenges of Bond Market Development in Bangladesh

1. Introduction

A developed and diversified financial system with a sound debt and equity market enhances risk pooling and risk sharing opportunities for investors and borrowers. This also provides a safety cushion for banks as it helps move a crisis outside the banking system making it easier for the government to stand back. Bond financing reduces macroeconomic vulnerability to shocks and systemic risk through diversification of credit and investment risks. A mature bond market helps develop the derivatives market thereby facilitating hedging mechanisms and enabling greater diversification of risks by participants. Also, the wide variety of instruments available in a developed debt market results in gains to savers and borrowers. Besides, the coexistence of a developed domestic bond market and banking system helps each to act as a backstop for the other. [1]

As debt market uses market mechanisms for allocating and pricing of credit, it facilitates efficient financial intermediation. In particular, debt markets facilitate the availability of long-term funds for specific uses such as for infrastructure development and long-term industrial financing. 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 also facilitates reduction of bad loans as well. Furthermore, moral hazard arising out of deposit insurance as in the case of banks is mitigated since debt instruments are mostly rated and investor awareness and monitoring are greater.

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. It also makes the financial market more competitive by generating market based interest rates that reflect the opportunity cost of funds at each maturity and reduces excess dependence on the banking system. 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.

In Bangladesh, an efficient bond market can play a critical role in supplementing the banking system to meet the requirements of the corporate sector for long-term capital investment and asset creation. It can provide a stable source of finance when the equity market is volatile. The bond market in Bangladesh, however, is thin and at a nascent state. While the size of tradable government bonds is small, secondary trading of government bonds is rare and there has been rarely any public issue of corporate bonds in the country's bond market.

In view of the need to make large scale long-term investments especially for financing rapidly increasing infrastructural requirements of the expanding economy, the availability of long-term funds for investment is a pre-requisite. Although banks can make some medium and long-term loans, their capacity to meet the long-term financing needs is constrained by mismatch in their assets and liabilities positions. Although the major business of most of the non-bank financial institutions (NBFIs) is leasing, some are diversifying into other lines of business like term lending, housing finance, merchant banking, equity financing and venture capital financing. However, in the absence of a vibrant bond market, the volume of financing by NBFIs is inflexible and inadequate to meet the economy's financing requirements.

[1] Bonds and stocks/equity are both securities, but the major difference between the two is that stock-holders are the owners of the company (i.e., they have an equity stake), whereas bond-holders are lenders to the issuing company. Another difference is that bonds usually have a defined term, or maturity, after which the bond is redeemed, whereas stocks may be outstanding indefinitely. The bond market (also known as the debt, deventure, or fixed income market) is a financial market where participants buy and sell debt securities, usually in the form of bonds.

The bond market in Bangladesh is currently characterized by excessive reliance on bank credit, government dominated debt instruments characterized by primary auctions based activity, relatively high and risk-free interest rates, nearly non-existent corporate and international bonds, absence of market based or benchmark yield curve, lack of institutional investors, poor confidence on the private sector, shallow capital market, lack of appropriate regulations and infrastructure, lack of expertise and innovation, inefficient and unaccountable trustees, high tax incidence and issue cost, and lack of product variations. Moreover, degree of efficiency of credit rating agencies, standards of accounting, auditing and disclosures, institutional infrastructure, prevalence of an environment for enforcement of contracts are important determinants of a well functioning bond market.

2. Characteristics of the Bond Market

Historical Background

With the change in economic policies toward private sector led development, the Industrial Corporation of Bangladesh (ICB) initiated efforts to establish a corporate debt market in 1985. The Central Depository Bangladesh Limited (CDBL) was incorporated as a public limited company in August 2000 to operate and maintain the Central Depository System (CDS). In line with the plan of automation, The Dhaka Stock Exchange (DSE) started trading on computers in August 1998 followed by incorporation of Central Depository System (CDS) in January 2004. Till to-date, there are four trustees of asset backed securities and mutual funds – Investment Corporation of Bangladesh (ICB), Bangladesh General Insurance Company (BGIC), Grameen Fund and Eastern Bank Ltd. In addition to ICB, Asset and Investment Management Services (AIMS) of Bangladesh started its operation as an asset management company in 2005.

Recent Developments

A series of initiatives have been taken in recent times to activate the country's bond market through revamping trading of the government approved securities in the stock exchanges. The aim is to develop the secondary bond market as a new window of investment for banks and financial institutions. For the purpose, Bangladesh Bank (BB) has created an alternative platform exclusively for primary dealers (PDs) to promote transactions of government bonds in the stock exchanges. The Securities and Exchange Commission (SEC), on the other hand, plays its part by guiding and encouraging selected brokerage firms to take part to activate trading of government bonds.

Fixed-income securities market in Bangladesh has experienced a number of recent changes. Bangladesh Bank has introduced new calendar for auction of treasury bills on a weekly basis which is announced on a half-yearly basis. This brings transparency in the money market and avoids mismatch between cash and debt management. To activate the secondary market, BB started repo and reverse repo auctions and issued licenses to PDs in government securities. On the other hand, rates on risk-free government savings certificates have been rationalized; preferential tax treatment for zero-coupon bonds introduced, and stamp duty on transfer of assets eliminated for securitization.

Earlier, BB selected nine PDs – eight banks and one NBFI – to trade in government approved securities in the secondary bond market and issued guidelines, which were amended later allowing commission for PDs and providing liquidity support to activate the secondary bond market.

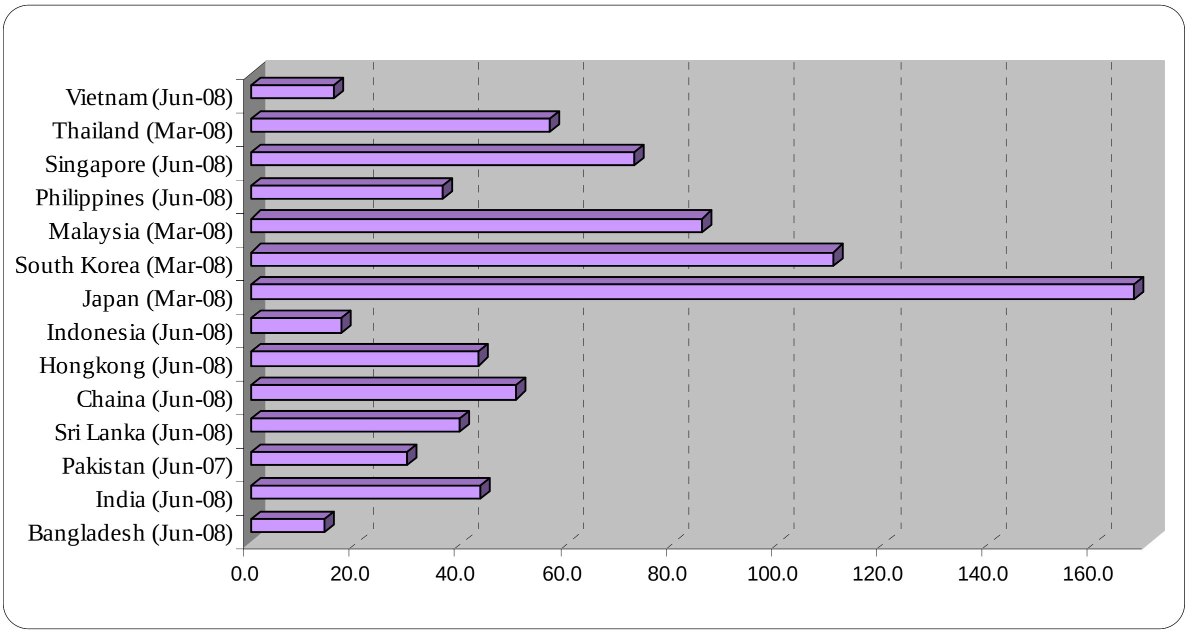
Although trading of bonds started in DSE since 2005, general investors are yet to participate in trading of saving instruments due mainly to higher transaction costs and other constraints, such as low liquidity condition of the bonds. Only a couple of banks have transacted in bonds to meet their internal demand. BB has been activating its newly opened window to invigorate trading of government bonds in the secondary bond market. In the process, BB purchased significant amount of government bonds through its new window from the National Credit and Commerce Bank Limited (NCCBL), a private commercial bank, for trading treasury bills through the window. In November 2007, BB opened this new window for trading only government bonds aiming to encourage the PDs to trade and bring dynamism in the secondary bond market.

Current Role of Bond Market

So far the bond market in Bangladesh has played a limited role in the economy. The size, access, efficiency and stability of the bond market across countries may be used to gauge the state of the bond market development in Bangladesh.[2] Compared with other regional markets and the size of the economy, the debt and equity market in Bangladesh is small where only the equity market is in active operation, while the bond or debt market is in its incipient stage.

For measuring the size, the ratio of private sector bonds to GDP, ratio of public sector bonds to GDP, and the ratio of international bonds to GDP are taken into account. The ratios of private sector bonds and international bonds to GDP are nearly non-existent in Bangladesh, while the ratio of public sector bonds to GDP is small relative to other regional economies. The size of the bond market in Bangladesh mainly consisting of public bonds and bills including NSD certificates stood at Tk. 753.3 billion or 14 percent of GDP during end June 2008 (Figure 1).

Figure 1: Size of Bond Market in Major Asian Economies (as % of GDP)



Sources: Bank for International Settlements (BIS) and publications of respective central banks

Table 1: Share of Equity in Investment Capital

(Tk. in billion)

Fiscal year	Newly issued debt and equity	Disbursement of term lending by banks and NBFIs	Total invested capital*	Equity as share of total capital (%)
FY 03	1.1	39.7	40.8	2.7
FY 04	10.7	66.8	77.5	13.8
FY 05	6.0	87.0	93.0	6.4
FY 06	11.9	96.5	108.4	11.0
FY 07	19.0	123.8	142.8	13.3
FY 08	25.3	206.1	231.4	10.9
Average	12.3	103.3	115.7	10.7

Source: *Bangladesh Bank Quarterly*, various issues, Bangladesh Bank.

The country's financial sector is characterized by dominance of commercial banks especially the state owned commercial banks (SCBs) who receive most of their funds in the form of deposits which are channeled into lending. For developing an efficient and broad based debt market, a robust market of fixed income securities is essential. Fixed income securities first came into existence in 1987 with the flotation of debenture by two companies. Trading of government treasury bonds started in December

[2] A recent World Bank report on financial sector development indicators (FSDI) lists several criteria to gauge the state of bond market development in terms of size, access, efficiency and stability across countries. See www.fsdi.org for details.

2005 at the DSE. Till the end of June 2008, eight debentures (no new debenture was issued after 1999), 84 treasury bonds with different maturities, and one corporate bond (floated in 2007 by the Islamic Bank Bangladesh Limited named as IBBL Mudaraba Perpetual Bond) are being traded in the country's capital market.

The equity market witnessed substantial growth in terms of market capitalization and share prices during FY08. Building on recent momentum and investors' confidence, the robust performance in the country's capital market continued during the year with 91.5 percent and 39.6 percent growth in market capitalization and general index respectively. On other hand, market turnover of DSE stood at Tk. 209.2 billion, reflecting a growth of more than 200 percent in FY08. Table 1 shows the share of equity against term lending by banks and NBFIs as a source of investment capital ('new issue of equity and debt' on DSE vis-à-vis term lending by banks and NBFIs). Data over FY03 to FY08 show that the share of equity hovers around an average of 10 percent of total investment capital ranging between 2.7 percent and 13.8 percent. The share of equity in total invested capital remained over 10 percent since FY06 reflecting signs of improvement in capital investment from equity and debt rather than loans from banks and NBFIs.

Table 2: Outstanding Stock of Treasury Bills, Bonds and NSD Certificates

(Tk. in billion)

Instruments	Jun 06	Dec 06	Jun 07	Dec 07	Jun 08
T Bills					
28- day	14.6	30.3	16.0	25.0	11.0
91- day	1.1	13.3	21.9	28.0	23.3
182-day	1.1	4.5	4.8	13.0	16.4
364-day	4.5	6.3	14.1	25.0	30.3
2-year	19.5	13.0	11.6	9.5	4.0
5- year	84.9	84.9	72.0	26.0	16.5
T Bills Total (A)	125.7	152.3	140.4	126.5	101.5
BGTB					
5-year	13.7	28.5	38.4	62.4	78.4
10-year	12.8	32.6	48.3	72.4	96.3
15-year				6.0	12.0
20-year				3.0	6.0
BGTB Total (B)	26.5	61.1	86.7	143.8	192.7
Sub Total (A+B)	152.2	213.4	227.1	270.3	294.2
NSD Certificate	394.6	409.6	436.4	444.3	459.1
Total	546.8	623.0	663.5	714.5	753.3

Source: *Bangladesh Bank Quarterly*, various issues, Bangladesh Bank.

Table 3: Percentage Share of Government Securities in Total Debt/Savings Instruments

Period	T-bills (28, 91, 182, 364 day, 2 & 5 year)	BGTB (5 year & 10 year)	NSD certificate (3 year & 5 year)
December 2003	10	00	90
December 2004	33	02	65
December 2005	28	03	69
December 2006	24	10	66
December 2007	18	20	62
June 2008	13	26	61

Note: 2-year & 5-year T-bills were discontinued in 2005 and 5 year & 10 year BGTB were introduced in December 2005.

Source: *Bangladesh Bank Quarterly*, various issues, Bangladesh Bank.

The domination of government instruments in the debt market still persists where the financial sector is characterized by high share of investment channelled from domestic savings in the form of bank deposits. The outstanding size of various government instruments displays a mixed trend during June 2006-June 2008 with a predominant share of NSD certificates. Total outstanding size of various t-bills declined in FY08 and stood at Tk. 101.5 billion at the end of June 2008 from Tk. 140.4 billion during end June 2007. On the other hand, total outstanding amounts of various BGTB instruments and NSD certificates increased to Tk. 192.7 billion and Tk. 753.3 billion respectively at the end of June 2008 (Table 2).

Table 3 shows the share of various categories government securities, e.g., t-bills, BGTB, and NSD certificates during December 2003-June 2008. In line with the long-run trend, the share of NSD certificates in total debt/savings instruments witnessed moderation while the share of BGTB increased. The share of BGTB in total debt/savings instruments increased to about 26 percent in June 2008 virtually from zero in December 2003. The share of NSD certificates in total debt/savings instruments, on the other hand, declined to 61 percent in June 2008 from 90 percent in December 2003.

3. Key Constraints and Challenges

Several economic and financial constraints may be identified for the slow progress in bond market development in Bangladesh.

Weak regulatory and governance infrastructure

A dedicated set of regulations and required infrastructure are important for the development of an active bond market. But Bangladesh lacks in this regard. However, despite the absence of an umbrella law, there could have been notable market activities had there been strong policy support. Until recently, there has been little government initiative and policy support to develop the financial and infrastructural base for nurturing the debt market. The government has recently taken some measures including intended listing of two new sovereign bonds at the bourses for the first time The SEC has now framed a guideline for issuance of debt securities.

The general investors’ confidence on the private sector is still shaky partly due to the absence of a clear regulatory regime. In the past, a good number of publicly traded debentures issued by reputed corporate houses through IPOs failed to service the interest coupon and principal payment obligations in time. There are instances where the SEC had to intervene after a long and tangled process but there was no visible legal redress for the debenture-holders. Another important limiting factor is the limited coverage of the activities of the credit rating agencies. As a result, there is little scope for initial rating to evaluate eligibility to make public issue of debentures. Further, surveillance or continuous rating could not be carried out to get early signals on a company's financial condition. Similarly, overlapping regulatory powers on the money and bond markets by the BB and SEC create scope of confusion among the issuers and market intermediaries The governance of the debt securities regime is weak and a disincentive along with the absence of arbitration institutions.

Conventional long-term financing vis-à-vis bond financing

Private companies including financial intermediaries and large businesses have little interest in launching new debt products in the bond market to raise long term funds, due to high interest rates (14-18 percent) and high non-interest fees given to dealers, trustees and others and interest costs to be given to the bond buyers. The non-interest cost of public issue of debenture is initially high. An issuing company is required to pay almost 6-7 percent of the total amount of debentures issued that includes stamp duty /registration fees and charges to trustees and the expenses incurred in publishing prospectus in newspapers, printing allotment letters, and debenture certificates. This tends to discourage companies from issuing debentures to the public since obtaining debt from commercial banks, share market IPOs and NBFIs are relatively less costly and procedurally simpler with lesser compliance obligations.

There exist distortions in the bond market caused by the wide use of National Savings Certificate (NSD) instruments by the government offering above-market returns. Thus breaking the conventional high risk-high return and low risk-low return financial rule fails to generate adequate interest on bond borrowing by the corporate bodies, which also hamper the development of the active bond market. The high NSD rate establishes a high benchmark rate for corporate fixed income securities, creating disincentive to invest in corporate securities. Thus government instruments seem to crowd out corporate borrowers and bank deposits. Also, the size of the share market is rising rapidly as reflected in the increasingly higher rate of market capitalization. New IPOs are increasingly being off-loaded to meet funds needed for long term investment by the private sector. These options are considered less costly than bond funding though such sources of fund raising have the added difficulty of ensuring collective interest of all share holders as owners.

Lack of broad-based market structure

It is important to have a strong investor base in order to ensure bond market growth. In Bangladesh, the institutional investor community (like investment and merchant banks, mutual funds, pension and provident funds, and life insurers) has not developed satisfactorily due to multifarious impediments. In case of mutual funds, Investment Corporation of Bangladesh dominates the entire market. Only two private mutual funds are available in the market. Newly licensed merchant banks are yet to make any tangible mark in the development of the market. The government pension funds are essentially non-funded and non-accounted for liabilities, provident and insurance funds restrained under age old qualitative and quantitative restrictions and growth of private mutual fund retarded under stringent regulatory framework and an uneven playing field. Moreover, insurance companies in Bangladesh prefer to invest in fixed deposits. Of the institutional investors, banks and other financial institutions are the main investors in fixed income securities. But these institutions basically invest in government securities in order to maintain the Statutory Liquidity Requirements (SLR) and they hold these securities till maturity, which restricts market liquidity

There exist supply-side constraints as well such as the lack of the benchmark rate or yield curve of bonds. The government does not issue long-term transferable instruments and the interest rates on the popular government saving instruments are administered. As such, no benchmarking of 'risk-free rates' or the risk-free premium is possible. The proxy 'bank rate' or the 'fixed deposit' rates of commercial banks are not a reflective and reliable substitute. Therefore, a mid or long-term yield curve could not be developed that characterizes the relationship between interest rates in the economy and the term to maturity. Benchmark yield curve is used as an indicator to measure the current term structure of interest rates, to form the basis for valuation of all fixed income instruments (for pricing different debt securities), to forecast future interest rate movements and associated risk and also to select miss-priced securities in active bond portfolio management. The absence of such long-term risk free yield curve for government securities is a key hindrance to the development of an active bond market. In recent years, the T-bills have been made market based where the demand is overwhelmingly from commercial banks to comply with the Statutory Liquidity Requirement (SLR).

The capital market is yet to emerge as an effective investment avenue to most of the small savers on the one hand and attractive avenue for the corporate bodies in raising fund on the other. The market lacks high quality equity on the stock exchange because of delays in privatization of state-owned enterprises, high listing costs and few IPOs. The negative spill-over effect of the grim capital market performance also dampens potential public issue of debt securities. However, with recent resurgence of the market the appetite for investment grade securities has again been pronounced that could unleash fresh demand for listed debt securities.

General lack of expertise and innovation and the absence of institutions in bringing variations in debt products have kept the market uninteresting. Although BB has now issued PD licenses to selected banks and NBFIs and the SEC has initiated the process of appointing eligible stock brokers for trading of government securities at the bourses, they lack necessary skills and competence in identifying attributes, rights and obligations of parties in debt securities. Public sector borrowing has been riddled with lack of transparency that fails to proffer any reliable demand-supply scenario in which an efficient debt market can function. Because of the frequent shifts and the ad hoc culture and volatility of demand, many of the debt instruments could not be designed to be publicly traded that could fuel a vibrant market structure of bonds--both corporate and public.

4. Policy Suggestions

Despite earlier set backs, the bond market in Bangladesh is ready for a rapid take off. Recent developments and events have already created an environment conducive to fostering the debt market. A number of financial institutions have sold bonds or debentures to institutions. Further, the Islami Bank Bangladesh Limited has issued a perpetual bond and so far its market response is positive. It is also expected that a number of institutions will float bonds through securitization in the near future. A sustainable and deep bond market needs enabling policies. The following actions and policy measures need priority in order to create an effective bond market in Bangladesh.

To develop a strong corporate bond market, an important pre-requisite is to ensure a fully functioning regulatory body such as the SEC. Moreover, there should be coordination on a regular and collaborative basis to address the accountability, transparency and compliance issues of the bond issuing agency and their trustees. Also, proper regulation of stock brokers, sub-brokers, share transfer agents, merchant bankers, underwriters, portfolio managers, investment advisors, and other intermediaries who are associated with the securities markets is a priority. Besides, the number of PDs along with their underwriting capacity needs to be enhanced.

Various regulatory steps are needed to encourage the promotion of the corporate bond market. For example, development of various corporate debt instruments may be imposed as obligations on behalf of the companies which would create market infrastructure for funds to ensure enabling environment for the secondary bond market. Also, facilitating the entrance of major market players such as insurance companies and mutual funds to invest in the bond market would be a priority policy. The provident funds and insurance funds are not generally allowed to invest in stock market instruments. To begin with, a part of these funds may be allowed to be invested in marketable instruments subject to prudential guidelines, which may necessitate the supply of lucrative debt instruments.

Along side the floatation of new government as well as private bonds, reduction in the interest on government savings instruments (NSD certificates) and withdrawal of competitive savings instruments with bonds would boost the demand for debt instruments. Also, the registration fee for trust deeds and trust fees could be reduced in order to provide incentives to bond issuing companies. Similarly, interest received by individual investors on bonds/debentures, approved by SEC, may be fully exempted from tax and investment by other investors may be given tax-exempt status up to a certain limit. The tax rates/relief available to investors on zero coupon bonds may be extended to all other bonds/debentures approved by SEC.

The regulator’s enforcement action should ensure that all issues of debentures are rated by independent rating agencies prior to issue. Companies issuing bonds/debentures to public may be rated periodically to keep track of issuing company's financial position. It is also important to allow private institutions to play the role of trustees which brings transparency and accountability from trustees and corporate/companies playing in the bond market. In view of making the task of credit rating agencies and trustees easier and faster, the opening of new credit agencies and trustees may be encouraged.

Bond maturities need to be diversified (such as between one year and seven years) so as to give the investors with different maturity profiles and the option of purchasing debentures with different maturities. Moreover, to facilitate liquidity of marketable bonds, discounting facilities may be provided by the financial institutions. Coupon rates and other issuing conditions of debentures need to be determined by market forces. Coupon rates may differ according to the rating of the issuer accorded by independent rating agencies. In order to make long-term investment more attractive, issuers may find it useful to increase the coupon rate as years go by, e.g. 9 percent in the first year, 10 percent in the second year, 11 percent in the third year and so on. Such increasing coupon rate methods would be useful, especially if the investor is given the right to call for redemption of the bonds at the end of each year so that he/she may choose to hold them to enjoy a higher coupon rate. In addition to the above, several long run policy measures are required to ensure sound development of the country’s bond market.

In order to meet the emerging requirements of the growing economy, public utilities and infrastructure projects need to raise a part of their finance through issuing marketable bonds. The process would be led several priority sectors such as housing, transport, and telecommunications. To facilitate the participation of small investors, the bonds could be split into small denominations. The existing public utilities and infrastructures could also securitize debts by issuing marketable bonds. Also, industrial companies could be encouraged to replace a portion of their bank/DFI loans with marketable bonds. In this context, introduction of varied assets including housing finance and mortgage backed securitization could play important roles.

A large and diversified investor base is important for ensuring strong and stable demand for both public and private securities. In this respect, the policies should focus on facilitating the development of institutional investors and encouraging foreign investors to participate in the local bond market which will enhance the credibility of the bond market. For the purpose, the CDBL should be equipped with easily accessible e-investor data base and e-based trading of bonds. The methods of revolving underwriting facility (RUF) may be introduced so that companies can issue short-term debentures whenever necessary. This will provide a system in which consortiums of underwriters can make commitment to the issuing company to purchase all unsold portions of the short-term debentures which may be issued from time to time during a certain period (e.g. five years) up to a maximum amount.

Along with strengthening corporate governance and improving disclosure and transparency in business transactions to create confidence of investors and issuers alike, the development of an effective inter-bank money market and a benchmark money market rate to assist secondary trading should be given priority. In principle, efficient bond markets must encompass a mobile primary market, a fluid secondary market, transparent rules and regulations, a conducive tax system, market rules and awareness, well-functioning settlement and custody systems, and a trustworthy rating system. Finally, public awareness/consensus on the roles of a corporate bond market and its operation mechanism is essential for developing an active secondary market of corporate bonds. To this end, regulators like SEC, Bangladesh Bank, and Ministries of Finance and Commerce and organizations like FBCCI should support research on different aspects of bond market development in order to devise appropriate policies and implement supportive measures.