

# CPD Dialogue on State of the Capital Market and Recent Policy Initiatives

Presentation on

Malgovernance, Malfunction and Mistakes

**Stabilising the Capital Market of Bangladesh  
Addressing the Structural, Institutional and Operational Issues**

Presentation by  
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12 December, 2011

Organised by



CENTRE FOR POLICY DIALOGUE (CPD)  
B A N G L A D E S H

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CPD team is grateful to  
Professor Mustafizur Rahman, Executive Director, CPD and  
Dr Debapriya Bhattacharya, Distinguished Fellow, CPD  
for their valuable advice in preparing the report.

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# 1. Introduction

- The capital market of Bangladesh is indeed in grave crisis.
- Between Dec. 2010 and Dec 2011 (8 Dec) all market related indicators have significantly lost their values.
  - DGEN 45%; market capitalization 32 %; daily trade value 94%.
  - The situation was same for the CSE as well.
- P/E ratio has declined from around 30 to 12 within this period.
  - Market did not respond towards this positive change
  - Indication of ‘loss of confidence’
- Various initiatives have been undertaken and many are in the process of implementation
  - Most of those initiatives were chosen from an ‘inappropriate’ premise.
- Extreme malgovernance coupled with a number of failures to undertake proper initiatives has made the market dysfunctional.

# 1. Introduction

- This presentation has three parts
  - First part provides a brief review of the problem of the capital market;
  - Second part provides a critical review of the initiatives undertaken to stabilise the market and their implications on the market;
  - Third part put forward specific recommendations for medium term stability of the market.

## 2. Benchmark Condition in the Capital Market

### *2.1 Problem is beyond market inefficiency*

- Inefficiency of Bangladesh's capital market is well known.
- The problem is beyond inefficiency
  - It is related with malgovernance (CPD, 2010; CPD, 2011; Probe Committee Report, 2011)

### *2.2 Lack of transparency in BO accounts*

- Serious dearth of transparency in case of authenticity of the information, legality, and accountability
- Establishing transparency in BO accounts would be one the most critical challenges

### *2.3 Bull cartels controlled the market-Are they disappeared?*

- A large part of the market behaviour was influenced by a number of bull cartels.
- Difficult to take measure under the existing weak surveillance and monitoring system and legal base.

## 2. Benchmark Condition in the Capital Market

### *2.4 Book building system turned to be manipulating instrument- Are the changes sufficient?*

- It turned out to be a mechanism of manipulating market prices, instead of ensuring competition
- Recent changes in the book building system have reduced scope for malpractices.

### *2.5 Rampant use of placement shares- How effective are the changes?*

- Due to lack of proper rules, placement shares were widely used to distribute among influential quarters.
- Recent changes in the placement shares system streamlined the mechanism

### *2.6 Serial trading is a popular malpractice*

- Prevalence of multiple BO accounts gave market players ample scope to carry out serial trading. such activities are illegal according to the SEC laws.

## 2. Benchmark Condition in the Capital Market

### *2.7 Insider trading is an open secret – How can it be stopped?*

- Price-sensitive information is leaked out earlier or rumors spread out.

### *2.8 Weak audit reports of the listed companies*

- More than 20% of the listed companies were audited by firms which had no affiliation other than the ICAB in 2010
  - Leaves ample opportunities and scope for misuse of the audit reports

### *2.9 Questionable operations of a number of merchant banks*

- A number of merchant banks were found to disburse margin loans over the stipulated limit
- A number of merchant banks were unable to be issue -manager
- Some merchant banks are alleged to act as ‘brokerage houses’

## 2. Benchmark Condition in the Capital Market

### *2.10 Retail behavior of financial institutions*

- Some of the institutional investors, particularly financial institutions, participated in the market as retail trader

### *2.11 Faulty operations of commercial banks*

- A number of commercial banks violated the stipulated rules and regulations related to investment in the capital market
- Currently most of the banks have investment within the stipulated level

### *2.12 Oversight of the Central Bank*

- Central Bank took a flexible stance with regard to maintaining the compliance standard of commercial banks.

## 2. Benchmark Condition in the Capital Market

### *2.13 Participation of small investors in the 'Keynesian Beauty Contest'*

- There was an unexpected rise of number of investors in the stock market.
  - Since the collapse, about 0.5 million account holders did not renew their BO accounts.
- A large part was participating in the 'Keynesian Beauty Contest'.

### *2.14 Weak operations at DSE/CSE*

- Conflict of interest in DSE/CSE's involvement both as price fixer and engaging officials as investigators.
- Conflict of interest between the DSE/CSE management and brokerage houses owned by them.

## 2. Benchmark Condition in the Capital Market

### *2.15 The SEC has yet to emerge as an efficient regulator*

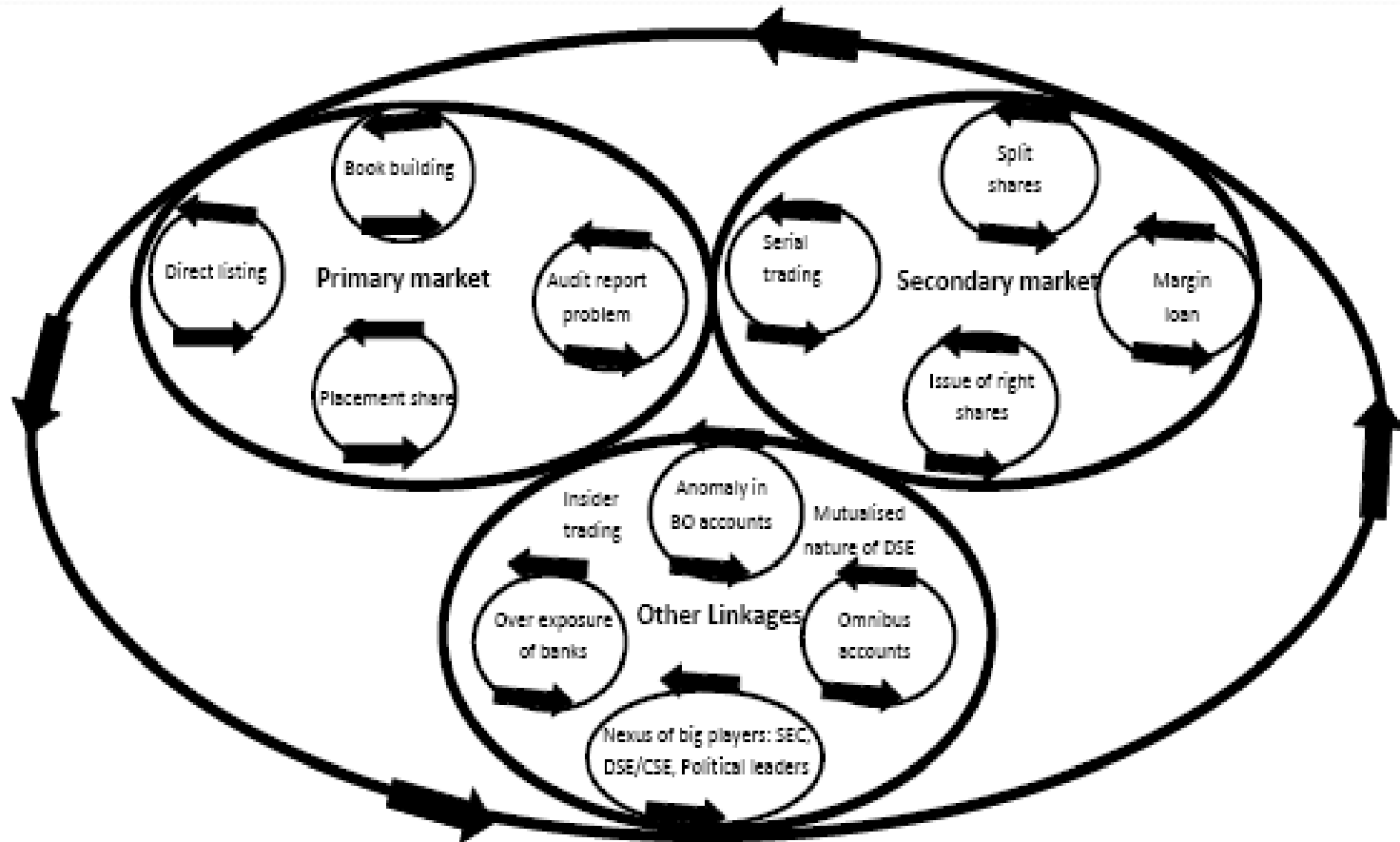
- Instruments applied by the SEC during the crisis were found to be either inappropriate or inefficient.
- No surveillance software; Limited office staff.
- In most cases the SEC has merely warned the companies/persons

### *2.16 Lack of Coordination*

- The relationship among the SEC, the (MoF) and other related institutions is likely to be against the principle of regulating the market.
- The Parliamentary Standing Committee for the MoF in some instances also took “advisorial position”.
- Lack of coordination among different financial markets including debt, equity and bond markets.

## 2. Benchmark Condition in the Capital Market

### 'Toxic' Elements in the Capital Market



Source: Prepared by the authors

## 3. Policy environment after the collapse in December, 2010

### 3.1 *Announcement of measures by the Ministry of Finance*

- The most noticeable change after the collapse was replacement of the previous Committee of the SEC.
  - It is ‘one of the important but not all’ what CPD (2011) referred as ‘the restructuring of the SEC’.
- The MoF announced 36 point measures.
  - Decided to take action against people involved in those illegal activities.
- A taskforce was supposed to be formed to supervise the implementation of the probe committee recommendations.
- The MoF has formed 4-member advisory committee to get advisorial support on the capital market.
  - The scope of work of the committee is unclear.
  - Overlapping of their activities with SEC’s 17 member advisory board.

## 3. Policy environment after the collapse in December, 2010

### 3.2 *Measures supposed to be taken by the SEC*

- The SEC is supposed to investigate allegations against officials for manipulating the market
  - Re-examination of assets, investigation against several people and companies
  - The SEC under its new management has also prepared a 29 points work plan
- It seems that the SEC highlights more on legal issues.

### 3.3 *Measures taken by the Bangladesh Bank*

- Flexible position against banks over investment in the capital market
- Extended time line (till December, 2013) for commercial banks to be compatible with regard to single party exposure limit
- Taking action for diversion of fund to the capital market etc.

### 3. Policy environment after the collapse in December, 2010

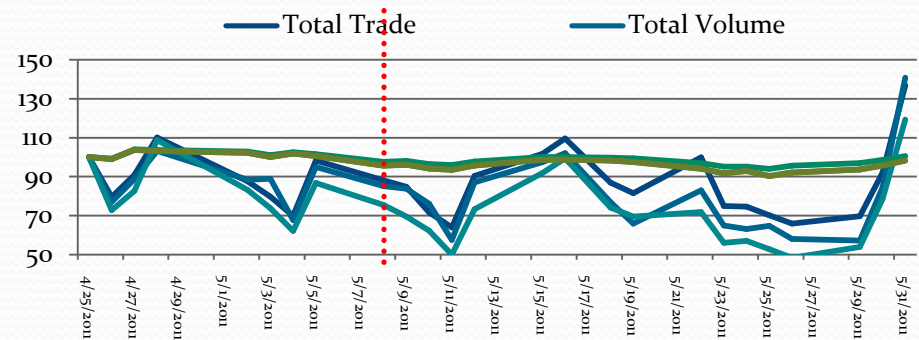
#### *'Fallacy of Liquidity Approach'*

- Injection of money in the secondary market has been regarded as a measure to revitalize the market when it 'really' suffers with lack of capital.
- In this logic immediately after the collapse of the market, the government took a number of measures
  - providing funds of Tk.600 crore to the state owned banks and ICB, formed "Bangladesh Fund", set up a "Stabilization Fund" .
- Under the National Budget for the FY12, government has announced a number of facilities targeting the capital market.
  - re-introduction of tax rebate facilities, tax-free facilities for mutual funds, time extension for the NBFIs to adjust their investment etc.
  - All these budgetary measures have direct and indirect implications towards raising fund for the ailing capital market

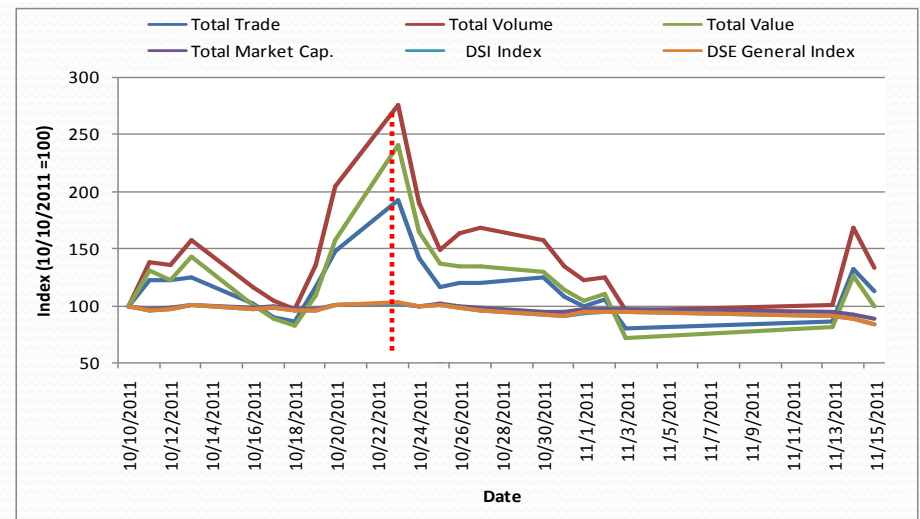
### 3. Policy environment after the collapse in December, 2010

- Figures show that there are hardly any positive movement in the market indices of DSE immediately after the announcement of two funds.
- This indicates that scarcity of capital is not the major problem of the market.
- In other words it could be mentioned as ‘Fallacy of Liquidity Approach’.

Market at the DSE before and after the Introduction of the Bangladesh Fund



Market at the DSE before and after the announcement of “Market stabilization Fund”



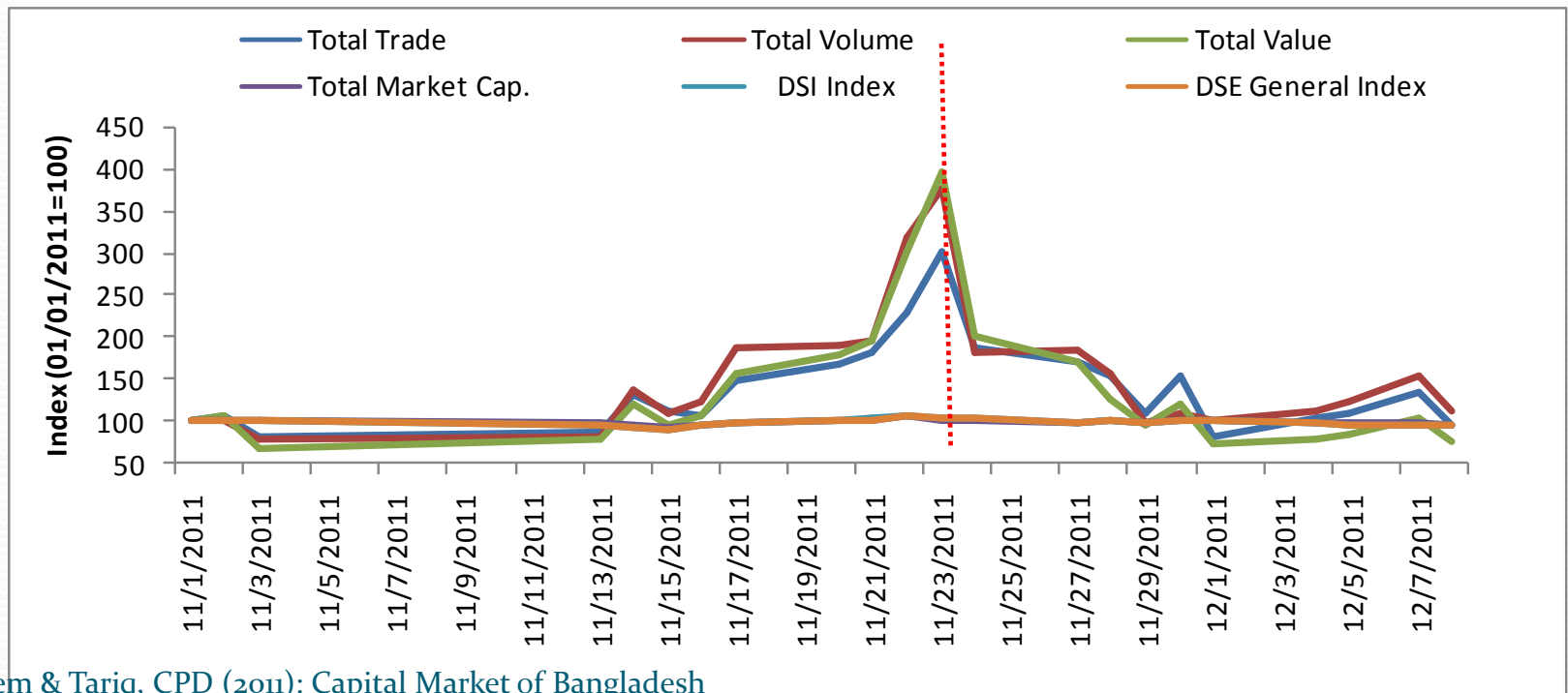
## 4. The SEC and the Bangladesh Bank: Recent Measures

- The Honorable Prime Minister in an unusual step met with major stakeholders
  - Put forward a number of directives with a view to stabilize the market.
- As part of this process, the MoF along with the SEC and other stakeholders prepared the much-hyped 'market rejuvenation package'
- This 21-point package focuses on greater participation of banks and other financial institutions in stock market
  - Setting up a 'special scheme' to provide support to the small investors who lost their capital.
- A number of medium term measures were also announced with a view to improve governance in the capital market.

## 4. The SEC and the Bangladesh Bank: Recent Measures

- It was expected that there would have some positive impact in the market.
  - Market did not turn up after the announcement of these measures.

**Movement of Selected Market Indicators before and after the Announcement of the Rejuvenation Package**



Moazzem & Tariq, CPD (2011): Capital Market of Bangladesh

Source: Based on DSE

## 4. The SEC and the Bangladesh Bank: Recent Measures

- A number of questions have been raised with regard to the package
  - Effectiveness of the measure (e.g. commercial banks' and insurance companies' stance to increase invest in the stock market)
  - Modalities to implement the measure (investment advisory service, strengthening the monitoring activities)
  - Long term implications on the market (e.g. relaxation in calculating 'capital market exposure' for banks, increase of fund collection limit for merchant banks beyond their parent companies).
  - Raises question regarding MoF's earlier announcement.
  - What would happen to SEC's earlier agenda of work?

## 4. The SEC and the Bangladesh Bank: Recent Measures

- The timeline suggested for implementation of various initiatives may not necessarily found to be practical.
- A major 'faulty' initiative would be providing financial support to the small investors who lost their capital.
  - Concerns are with regard to the justification, identification, operational modality and future concerns etc.
  - Justification of using government's revenue for providing financial support to a section of 'Keynesian beauty contestants'?
  - How do the small investors and their amount of losses to be defined?

## 5. Short term Outlook

- Although the short term outlook of the market is not promising, there are some measures in the rejuvenation package which would have positive impact on the market.
- Price-earnings ratio which rose to as high as 29.7 in November, 2010 has come down to 12.8 in 8 December, 2011.
  - Good market fundamentals
- Sponsor-directors of listed companies will have to own at least 30 per cent stakes of their respective companies.
  - SEC should closely monitor the process
- 10 per cent tax imposed on the profits earned by investments by foreign institutional and non-resident Bangladeshis will be withdrawn.
  - SEC should closely monitor the process

## 6. Suggested Measures with a view to Ensure Medium Term Stability

- It appears that there is almost ‘everything’ except ‘market’ mechanism to deal with the crisis in the capital market.
  - Different initiatives by regulators have resulted ‘malfunction’ state of the market.
- There is little to be gained through short term measures.
- The so called ‘market stabilisation’ or ‘market confidence’ would not be ensured unless appropriate measures are taken in a time bound manner

### 6.1 Policy stance and institutional dimensions

- The problems of the capital market need to be considered beyond ‘political’ stand
  - more importantly to be considered under the framework of a ‘market’ with the objective of reestablishment of the ‘rules of the game’ there.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.1 Policy stance and institutional dimensions

#### *a) Establish SEC's role as the regulatory authority of the capital market*

- The reformed SEC should make clear its working relationship with other stakeholders, immediately.
  - It should come out from its existing approach in maintaining relationship with MoF and market players.

#### *b) The MoF should facilitate statutory authority to be exercised by the SEC*

- Government should on principle agree that market could not function properly with the existing structural loopholes through injection of fund.
- The MoF should full autonomy in the SEC's decision making process.
- Advisory role of the Parliamentary Standing Committee should not create any conflict of interest in the capital market.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.1 Policy stance and institutional dimensions

#### *c) Maintaining financial discipline in the money market and strengthening its coordination with the capital market*

- Policy stance and policy support to other segments of the financial sector should not be at the cost of weakening the financial discipline in the banking sub-sector.
- Any measure targeting the capital market needs to be properly assessed by taking cognizance of its impact on the banking sector.

#### *d) The Central Bank should ensure its primary responsibility of maintaining a sound banking system*

- The Central Bank should strictly monitor the investment limit of each of the banks.
- The Bank Company Act should be revised to put further restrictions on banks' liabilities to be invested in the capital market.
- It should place necessary directives to commercial banks regarding diversion of funds.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.1 Policy stance and institutional dimensions

#### *e) Commercial Banks and Insurance Companies should not get diverted from their primary jobs*

- Banks and insurance companies should not get diverted their primary role.
- Given the high volatility and poor condition of the capital market, Banks should refrain from investing more in the market.
- Insurance companies under its jurisdiction should not go for excess investment in the capital market.

#### *f) Visible action needed with regard to investigation of fraudulent and illegal activities*

- The government should immediately form a task force to initiate investigation into the fraudulent practices in the country's bourses.
- Considering the power-relations of the big players, such investigations should be undertaken by the MoF.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.2 Operational and Monitoring Measures

#### *a) Enforce disciplinary measures against improper/illegal activities*

- The SEC should take disciplinary measures against its officials who were involved in various kinds of illegal activities.
- The SEC should penalize the brokerage houses adequately for improper settlement of account.

#### *b) Strengthen the surveillance mechanism of the SEC*

- Current strength of officials of the SEC needs to be increased.
- The SEC should strengthen its legal advisory support system as well as financial auditing and monitoring system.
- Appoint experienced and well-reputed professionals for these purposes.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.2 Operational and Monitoring Measures

#### *c) Transparency in transaction through BO accounts*

- The SEC should review the trading practices in the secondary market using the existing BO accounts.
- The SEC should immediately take measures to ensure transparency in BO accounts.
- Review and cross check the personal information of each of the BO accounts.

#### *d) BO accounts should be tagged with TIN*

- The SEC should make TIN number mandatory for all existing BO account holders.
- This will increase the number of tax-payers and revenue.

#### *e) Proper measure to reduce insider trading*

- Government's initiative regarding strengthening insider trading related laws to be structured properly.
- 'Prohibition of Insider Trading Regulations, 1992' by Securities and Exchange Board of India (SEBI) can be consulted.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.2 Operational and Monitoring Measures

#### *f) Review the current practices of evaluating the audit reports of listed companies*

- The SEC, DSE/CSE should review the current practices of the evaluating the audit reports.
  - Misreporting, false statement and various other unethical practices with regard to audit reports
  - A group of audit firms involved in these illegal activities needs to be identified
- Proper financial reporting standard to be followed under the proposed financial reporting act.
- Audit firms should operate under a legal framework that places responsibility for the financial statement of the company on the audit firm itself
  - It includes punitive measures for providing inaccurate information and statements.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.2 Operational and Monitoring Measures

#### *g) Injection of fund should not be the measure to stabilize the market*

- All measures targeting to inject money in the market should be suspended.
- Operation of existing 'Bangladesh Fund' and 'Stabilisation Fund' should be temporary stopped.
- Government should review its stand regarding the provision for allowing undisclosed money in the capital market. (Violation of Asian reporting standard)
  - More importantly, such an option will create obstacles towards undertaking investigations against illegal trading played by big players and made windfall gains.
- Given the situation of the market, offloading of government's shares of public companies would not help much to strengthen the operations of the capital market.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.2 Operational and Monitoring Measures

#### *h) Limiting the operations of brokerage houses and merchant banks*

- The SEC should review its policy with regard to operations of brokerage houses.
- The SEC should consider limiting the number of brokerage houses and merchant banks within a manageable limit.
- The SEC should target ‘problematic’ brokerage houses and merchant banks.

#### *i) Discourage short term trading in the stock market*

- Imposition of capital gain tax on short term trading which is currently applicable on institutional investors can be extended to private investors in case of short term trading.
- Advanced trading software needs to be installed both at the SEC as well as at brokerage houses.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.3 Management related measures

#### *a) SEC's advisory board should be reformed*

- The advisory board of the SEC should comprise of eminent persons having no stake in the market.
- The overexposure of the market related institutions and market players in the committee should be reduced with a view to get more rational and practical advisory support.
- Formation of small advisory committees on different issues as like in case of SEBI would be more effective
  - Given the size of the market in Bangladesh such initiatives would not be required now.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.3 Management related measures

#### *b) Demutualization at DSE/CSE with strong monitoring of the SEC*

- The separation of ownership and management of DSE/CSE from brokerage houses is required primarily to reduce problems associated with the day to day operation in the DSE.
- Reports about malpractices by some members of the DSE management have raised doubt as to what extent the so-called demutualization will be able to address such concerns.
- This implies that there will be a need for strong monitoring of the operation of the DSE after it is transformed into a private limited company.
- The process of demutualization should be completed within a stipulated time frame.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.4 Strengthening the Legal Framework of the Capital Market

- Bangladesh, as in many other countries, has the required laws in place to deal with most of the illegal activities and the punishment under these laws is also not much different than other countries
- The issue in most instances is that of enforcement of laws.
- In some cases, introduction of new laws may be necessary in view of the emergent situation and taking into cognizance fraudulent activities which are not covered by existing laws.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.5 Rational behaviour of investors

- Both the institutional and retail investors are alleged to be behaved as ‘retail traders’ in the market
  - The SEC should review the nature of trading behaviour of the institutional investors
- Small scale investors should behave rationally in the market
  - Should avoid any kinds of vandalise activities
  - Should not participate with the mindset of ‘subsistence’ level of living
  - Should not participate for short-term capital gain (e.g. T+3 etc.)
    - Rather they should participate for long-term gain

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.6 Improving the transparency and disclosure

- It is alleged that various web-based methods, mobile based techniques, TV and newspaper reporting etc. would have 'non-neutral' impact on the capital market of Bangladesh.
- There are in-depth global studies (Balakrishnan, Ghose, and Ipeirotis, 2008; Aman, 2010; Engelberg and Parsons, 2011; Peress, 2011) regarding the role of media in the capital market.
  - Media has strong role to play in terms of reporting market trends and market related information including its governance, operational practices etc.
  - It is found that specific kinds of reports may create artificial pressure in the market.

## 6. Suggested Measures with a view to Ensure Medium Term Stability

### 6.6 Improving the transparency and disclosure

- In this context, the policy of media houses/web-based social networking in Bangladesh with regard to media reporting on capital market and dissemination through web-based sources may need to be reviewed.
- Initiatives should be taken to strengthen analytical capacity
  - Ethical reporting with regard to the capital market



Thank you!