HIGH-LEVEL SUMMARY TECHNICAL ASSISTANCE REPORT

BANGLADESH

Local Currency Bond Market Development Diagnostic

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Prepared By

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High-Level Summary Technical Assistance Report
Monetary and Capital Markets Department

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The *High-Level Summary Technical Assistance Report* series provides high-level summaries of the assistance provided to IMF capacity development recipients, describing the high-level objectives, findings, and recommendations.

ABSTRACT: At the request of the authorities, an IMF-World Bank team undertook a technical assistance mission to Bangladesh, from July 5-17, 2023, to support efforts to develop the government local currency bond market. The mission assessed the current stage of the sovereign debt market and formulated policy recommendations for each of the six building blocks included in the Guidance Note for Developing Government Local Currency Bond Markets.[1]

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[1] The six building blocks consist of: Money Market, Primary Market, Secondary Market, Investor Base, Financial Market Infrastructure, and the Legal and Regulatory Framework.

Background

As requested by the Ministry of Finance (MoF), a joint mission from the IMF and the World Bank visited Bangladesh from July 5 to 17, 2023 to support efforts to develop the government local currency bond market (LCBM) and develop a sequenced action plan for LCBM development by the authorities and future technical assistance.[2] The Bangladeshi authorities view the development of the government LCBM as a pivotal source for stable funding and a cornerstone for broader financial market development. This emphasis is driven by rising financing needs and anticipated decline in concessional external borrowing. The mission assessed the current stage of Bangladesh's domestic sovereign debt market and formulated policy recommendations for each of the six building blocks included in the Guidance Note for Developing Government Local Currency Bond Markets.[3]

Summary of Findings

Bangladesh meets the preconditions necessary for the implementation of policies that can deepen the level of market development from its current developing stage. Although government securities are mostly oversubscribed in auctions, market clearing prices were not allowed till recently through devolvement to the Bangladesh Bank (BB) due to the dominance of monetary policy aimed at keeping lending rates below a certain level. This hindered functioning of the debt market. The heavy reliance of high-cost National Savings Certificates (NSCs) crowded out bond market funding while direct central bank financing in recent years and weaknesses in the bond market design deterred its functioning.

Although the financial market infrastructure (FMI) and legal and regulatory framework are assessed higher at emerging stages, all the other building blocks are assessed at developing stages. While there is no reliable short-term yield curve, the money market is dominated by unsecured interbank transactions due to several impediments of the repo market and the evolving monetary policy operating framework. The primary market is characterized by sound operating framework including transparency in issuance framework and benchmark bonds. The recent move to cease devolvement of auctions to the BB will support accepting market clearing prices.

Despite good transparency on secondary market transactions, the LCBM is illiquid reflecting low volume of trades. This is due to fragmented securities issuance structure, a narrow investor base with buy and hold behavior, the disproportionate application of the withholding tax on interest for securities traded and inadequate market making rules of PDs. With a bank dominated system, the institutional investor base is small and would require time to develop based on deepening of the overall financial system. The primary dealer (PD) system is found to be ineffective, partly due to weaknesses in its design.

[2] The mission team comprised Arindam Roy and Rose Nyongesa (IMF); Zsolt Bango and Jose Franco Medeiros de Morais (World Bank); and Guido Della Valle and Elias Kazarian (IMF External Experts). Mia Pineda (IMF) supported the mission remotely.

[3] The six building blocks consist of: Money Market, Primary Market, Secondary Market, Investor Base, Financial Market Infrastructure, and the Legal and Regulatory Framework.

Summary of Recommendations

Acceptance of market-clearing prices is crucial for LCBM development and requires upholding elimination of devolvement to the BB and PDs in auctions. As a next step, the underwriting commitment of PDs should be withdrawn immediately to ensure voluntary participation in the primary market. This should be calibrated with reform of the PD framework, implementation of liability management operations (LMOs) and reforms of NSCs with alignment to market yields of bonds for similar tenors.

The PD system would strongly benefit from a comprehensive reform of its regulatory framework aimed at selecting a smaller but active set of PDs. Consolidation of the PD system with committed entities by re-defining the eligibility and minimum performance criteria could ensure a better fit. Recalibration of the balance between their rights and obligations, and the setting of more realistic and systematically enforced obligations could enhance PD effectiveness to support the LCBM. For greater ownership of the PD system, the relationship between PDs, the MoF and the BB should be clarified.

Improvements in the money market should be underpinned by a transition to a complete interest rate corridor, complemented by a robust money market yield curve. The BB should desist from directly influencing T-bill rates, instead adjusting policy rates if needed. Fostering a thriving repo market would require addressing impediments, the most crucial introducing a master repurchase agreement. Improving the liquidity forecasting capabilities of the BB will be crucial but may take some time. In the interim BB could consider switching to a weekly fixed-rate, full-allotment auctions conducted at the policy rate to enhance the signaling of the policy rate, and BB's discretion in accepting bids should be lifted.

The operating framework for issuance of government securities would require more predictability. The authorities should adhere to the issuance calendar for bonds. Increasing the size of benchmark bonds supported by LMOs would support further development of the secondary market. Broadening the bank-dominated investor base is a longer-term endeavor, most promising efforts would be to focus on the life insurance industry and the recently established National Pension System, followed by expansion of the mutual fund sector.

Despite a proficient FMI and robust regulatory framework, a fortification is needed to support the development of the LCBM. Areas for focus would be to eliminate risks of failed settlement by introducing a securities lending facility, settling payments in the BD-RTGS system and linking the trading and settlement mechanism for unsecure interbank market to reduce counterparty risk. Reform of the tax law could boost market development by ensuring correct apportionment of withholding tax on interest for trades between coupon payment dates, ensuring appropriate tax treatment of repo transactions, and aligning the income tax law settings for non-resident investors with international common practices.

Progress on LCBM reforms should be closely monitored by a high-level inter-agency Steering Committee on debt market development. Several reforms would require coordination across various stakeholders led by the MoF.