November 2009

The Finance in the Capital Market and Credit Rating in Bangladesh[1]

Mitsuru Mizuno

Professor at the Graduate School of Business, Nihon University
4-8-24 Kudan-minami, Chiyoda-ku, Tokyo, 102-8275, Japan
Phone: ＋81-3-5275-9442
Fax: ＋81-3-5275-8277
E-Mail: mizuno.mitsuru@nihon-u.ac.jp
URL: http://www.gsb.nihon-u.ac.jp

This paper is part of the research on "Model Building on Standardization of Assessment Methods of Credit Risk in Major Asian Countries"

Center for China and Asian Studies
Nihon University College of Economics
1-3-2 Misaki-cho, Chiyoda-ku Tokyo 101-8360

Phone: ＋81-3-3219-3523
Fax: ＋81-3-3219-3529

[1] The author wishes to acknowledge the invaluable contributions of Professor M.S. Islam, University of Dhaka, and Mr. M. T. Islam, Credit Rating Agency of Bangladesh.

［Bangladesh］

Table of Contents

1. Financial/ Capital Market in Bangladesh

Bangladesh has achieved stable growth over the last 9 years (Table 1). It seems that the global financial crisis has not significantly affected Bangladesh mainly due to growth in exports and remittances, albeit pressures from the global slowdown are building up. Before the onset of the global financial crisis, a 6.5 per cent growth target for FY2009 appeared attainable. With the financial crisis in the developed countries unfolding and recession lasing longer than earlier anticipated, a growth rate in the range of 5.5 per cent to 6.0 per cent[2] is more likely in FY2009 which ends in June 2009. Although external debt is on the rise in recent years, it looks manageable because ratio of exports to external debt is declining.

Compared with the neighboring countries, the Bangladesh capital market is small and has yet to play a bigger role in the economy (Table 2). The share of domestic debt securities in the country's GDP was approximately 12% in 2006 and that of India and Pakistan was 35.9% and 26.3%, respectively. Likewise, equity market capitalization over GDP was substantially lower among the South Asian countries. Therefore, Bangladesh has to accelerate to develop the capital market because it 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 issuers.

Table 1: Bangladesh Profile

	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
POPULATION (mn)	128.1	129.9	131.6	133.4	135.2	137.0	138.8	140.6	156.0*
GDP per capita (US$)	360.0	360.0	350.0	370.0	410.0	440.0	450.0	470.0	532.3*
GDP (US$ bn)	45.5	45.4	47.2	51.7	55.9	57.6	60.3	67.9	83.04*
GDP real growth	6.0	5.3	4.4	5.3	6.3	6.0	6.6	6.4	6.2*
Consumer prices	2.8	1.9	2.8	4.4	5.8	10.4	6.8	7.2	10.9*
Trade balance ($ bn)	-1.9	-2.0	-1.8	-2.2	-2.3	-3.3	-2.9	-3.4	-5.6*
Merchandise exports, fob	5.7	6.4	5.9	6.5	7.5	8.6	10.4	12.1	13.1*
% change over previous year	7.9	12.6	-7.6	9.5	15.9	14.0	21.6	15.6	9.0*
Merchandise imports, fob	7.6	8.4	7.7	8.7	9.8	11.9	13.3	15.5	18.7*
% change over previous year	4.8	10.5	-11.5	13.1	13.0	20.6	12.1	16.6	20.8*
Current A/C balance ($ bn)	-0.4	-1.1	0.2	0.2	0.2	-0.6	0.6	1.0	-0.3
% of GDP	-0.9	-2.4	0.3	0.3	0.3	-0.9	0.9	1.4	-0.4
Reserves ($ mn)	1.5	1.3	1.7	2.5	2.7	2.9	3.5	5.1	5.5
(Months of imports)	2.3	1.9	2.1	2.9	2.8	2.5	2.7	3.3	3.0
External Debt ($ bn)	15.7	15.2	17.0	18.8	20.1	18.9	20.5	21.3	21.7*
% of GNI	32.2	31.4	34.3	34.3	33.7	30.0	31.1	31.3	26.1*
% of Exports	275.4	237.5	288.1	289.2	268.0	219.8	197.1	176.0	165.6*
Debt Service Ratio (%)	8.6	7.5	7.4	5.9	5.2	5.4	3.8	3.9	
Yield on 91-day Treasury bill				7.4	5.0	6.7	7.4	7.6	
DSE Index (end-period)	642.7	829.6	848.4	967.8	1971.3	1677.3	1339.5	3017.2	2795.3
Exchange rate (Sum/$, average)	52.1	55.8	57.9	58.2	59.5	64.3	68.1	69.8	68.5*

Notes: Symbol * indicates estimates.
Source: ADB, IMF, World Bank, United Nations

Table 2: Financial Market Profile (2006)

[2] Estimates of the Asian Development Bank.

	Domestic debt securities market		Equity market capitalization		Banking assets	
Economy	US$ billions	As % of GDP	US$ billions	As % of GDP	US$ billions	As % of GDP
South Asia						
Bangladesh	7.3	11.9	3.6	5.8	32.7	52.8
India	325.7	35.9	818.9	90.4	587.4	64.8
Nepal	1.3	15.1	1.3	16.3	4.3	53.8
Pakistan	33.4	26.3	45.4	35.3	50.7	39.4
Sri Lanka	13.7	50.8	7.8	29.8	10.3	38.2
Total	381.3	33.6	877.0	77.5	685.4	60.6
Selected East Asian economies						
China	1,183.6	44.4	2,426.3	90.9	3,509.9	131.6
Hong Kong, China	51.0	26.9	1,715.0	903.6	297.6	156.8
Indonesia	76.4	21.0	138.9	38.1	128.6	35.3
Korea, Rep. of	1,010.0	113.7	834.4	94.0	984.0	110.8
Malaysia	146.2	98.2	235.6	158.2	199.4	133.9
Philippines	44.9	38.4	67.9	58.0	51.5	44.0
Singapore	79.2	59.9	384.3	290.8	162.9	123.3
Thailand	109.7	53.2	140.2	68.0	228.7	110.9
Total	2,700.9	57.3	5,942.5	126.0	5,562.5	118.0

Source: World Bank "South Asian Bond Markets" (2008)

(1) General feature of the capital markets in Bangladesh

The capital market in Bangladesh is still at a developing stage. But, there was a steady progress in the capital market in the past due mainly to the government's continuous efforts to develop a sound securities market. As shown in Table 3, there had been continuous development of the capital market over the years. As of the end of 2007, there were 350 securities listed on the Dhaka Stock Exchange with a market capitalization of US$ 10.82 billion. The average growth of market capitalization had been 34.8 percent per annum over the last 10 years. The transaction volume also increased significantly with an average growth rate of 28.5 percent during the same period. The average size of companies in Bangladesh is very small compared to those of other countries. The company had an average issued capital of only Taka 331 million in 2007. Owing to the tiny size of companies, shares are concentrated in a few hands within a few years after becoming public. This is the main reason for thin trading and infrequent trading of stocks of some companies. The foreign portfolio investment in Bangladesh capital market is insignificant. In the 1990s, there had been some foreign portfolio investment. Much of these investments were made in private placement of new issues. However, in subsequent years, these investments were mostly withdrawn with the introduction of lock-in period for privately placed securities. While there is no official record of foreign portfolio investment in the capital market, an assessment of the Securities and Exchange Commission (SEC) indicates that the investment of foreign portfolio investors in Bangladesh is roughly 2.5 percent[3].

Table 3: Key Statistics of Capital Market in Bangladesh

Year	Number of Listed Securities	Market Capitalization (Billion)		Transaction (Billion)		Transaction / Market Cap. (%)	Price Index
		in Taka	in US $	in Taka	in US $		
1998	228	50.25	1.04	34.84	0.72	69.33	540.22
1999	232	44.78	0.87	38.96	0.76	87.01	487.77
2000	241	62.92	1.17	40.27	0.78	64.00	642.68
2001	249	63.77	1.12	39.87	0.74	62.52	817.79
2002	260	71.26	1.23	34.98	0.61	49.09	822.34
2003	267	97.59	1.67	19.15	0.33	19.63	967.88
2004	256	224.92	3.81	53.18	0.90	23.64	1971.31
2005	286	233.08	3.52	64.84	0.98	27.82	1275.05
2006	310	323.37	4.67	65.08	1.10	20.13	1321.39
2007	350	742.20	10.82	332.87	4.71	44.85	2535.96

Note: Securities include stocks, bonds, debentures and mutual funds.
Source: DSE, CSE and SEC reports.

The supply of new securities in the market had been small in Bangladesh. As presented in Table 4, the number of new issues and the funds raised from the market were limited. During the past ten years, an average of 10 companies made public floatation of shares and raised funds of about Taka 2.77 billion per year. In spite of the efforts of the government to increase the supply of new floatation of shares, there were no conspicuous results. The major impediment to public offering of securities is with the attitude of entrepreneurs. It is widely believed that fear of losing control over the company still prevails among the entrepreneurs and sponsors. This prevents many entrepreneurs from floating shares in the market. Accordingly, as stated above, the controlling interest is retained for most of the publicly traded companies by the sponsor directors and their family members.

The debt securities market is small. Government debt securities such as treasury bills, treasury bonds and national savings certificates (NSA) dominate the market, among which NSA account for roughly two-thirds. The corporate bond issues had been very occasional and had been stagnant due to a lack of varied corporate debt supply. This is because, in general, companies prefer to rely on banks for funds rather than on the bond market, thereby avoiding the need to comply with disclosure and governance norms. These imply that the capital market had not been effectively utilized as a

[3] M.S. Islam (2008) , "An Examination of the Securities Markets in Bangladesh"

vehicle for financing by companies.

Table 4: Capital raised in the capital market

Year	Number of initial issues			Capital raised (Million Taka)		
	Stocks	Corporate bonds	Total	Stocks	Corporate bonds	Total
1998	5	1	6	302.10	50.00	352.10
1999	10	1	11	975.00	20.00	995.00
2000	7	0	7	422.85	0.00	422.85
2001	11	0	11	572.20	0.00	572.20
2002	8	0	8	450.20	0.00	450.20
2003	14	0	14	2,952.67	0.00	2,952.67
2004	3	0	3	588.04	0.00	588.04
2005	18	0	18	2,310.50	0.00	2,310.50
2006	10	0	10	12,624.83	0.00	12,624.83
2007	13	1	14	3,463.97	3,000.00	6,463.97

Source: DSE, CSE and SEC reports.

(2) Financial markets and corporate finance

In Bangladesh, major source of corporate finance is banks and non-bank financial institutions (NBFIs). As shown in Table 5, during the past 6 years, about 90% of corporate finance was secured by banks and NBFIs, and the rest by the newly issued debt and equity. This indicates that there is a need for improvement in fund raising from equity and debt markets rather than loans from banks and NBFIs.

Table 5: New issue of equity and debt on DSE vis-à-vis term lending by banks and NBFIs

Amount in Billion BDT

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	2.70
FY 04	10.7	66.8	77.5	13.81
FY 05	6.0	87.0	93	6.45
FY 06	11.9	96.5	108.4	10.98
FY 07	19.0	123.8	142.8	13.31
FY 08	25.3	201.5	226.8	11.16
Average	**12.33**	**102.55**	**114.88**	**9.73**

Source: Bangladesh Bank Quarterly, various issues.

The banking sector consists of commercial banks; 30 domestic private banks, 9 foreign ones, and 4 nationalized commercial banks (NCBs). In addition, there are five specialized banks or financial institutions – two of them are for the agriculture sector, two of them for the industrial sector and the remaining one for the small industries. But, banking sector is characterized by the dominating presence of commercial banks, especially the NCBs. Private banks have gained in market share in recent years, in part because of the ongoing restructuring of the nationalized commercial banks and in part because the private banks offer higher interest rates on deposits.

In Bangladesh, the Companies Act 1994 defines the basic legal framework for the formation, capital raising, financial reporting and management of joint stock companies. The SEC monitors and controls the securities market. It approves an issue of capital by the companies and the prospectus and other documents. In addition to these, the SEC has developed and promulgated separate rules to define the responsibilities and behavior of different market players. These rules are related to mutual funds, public issue, right issue, credit rating, over-the-counter trading, margin trading, insider trading, merchant banking and portfolio management, stock dealers, brokers and authorized representatives, asset-backed securities, custodial service, acquisition of shares, and depository functions.

Under the Credit Rating Companies Rules of 1996, all debt securities require a rating by a credit rating agency. A company making public issue of shares will also require a rating if the shares are issued at a premium (at value higher than the par value). The company providing rating services will have to be registered with the SEC. In 2006, SEC issued new rules which provide the legal framework for making public issue of securities in Bangladesh. The rules were designed to protect the interest of investors. It defines the structure and contents of prospectus to ensure disclosure of material information to the investors. The prospectus must include, apart from the usual contents, the risk factors of the companies, directors' relationships and related transactions, due diligence certificate from issue manager and underwriter, executive compensation, and executive options.

(3) Bond markets in Bangladesh

The bond market has played a limited role in the Bangladesh economy. The bond market is shallow compared to the neighboring countries. Measures are required to improve both the depth and the breadth of bond markets in Bangladesh. At the end of 2005, the outstanding bond volume per GDP was only 1.4%, compared with India (34.8%), Pakistan (30.9%), Sri Lanka (53.6%), and Nepal (9.8%). The share of the Bangladesh bond market in South Asian countries was a mere 0.2%, the smallest among the five countries.

Government debt dominates the market for fixed-income securities. Table 6 shows the composition of government domestic debt in Bangladesh. The national savings certificate is an instrument to mobilize the savings of small investors at interest rates higher than that of the market. Apart from the national saving certificate, government funding instruments are composed of treasury bills (28, 91, 182, 364 days) and treasury bonds. The government has been issuing 5 and 10 year treasury bonds since December 2003, and 15 and 20 year bonds since July 2007 in order to meet its borrowing needs. The government has virtually changed the capital raising pattern from a concentration in treasury bills to a significant increase in treasury bonds. As a result, the ratio of treasury bonds to treasury bills rose from about 20 to 80 in 2005 to 80 to 20 in 2007. Most of the buyers of treasury bonds are financial institutions. Commercial banks are obliged to buy government securities as approved security to meet their statutory liquidity requirement (SLR) under the Banking Companies Act. It is still a captive market. Banks and financial institutions having SLR obligation are the only participants in this market. But these bonds are rarely traded on the stock exchange.

The transparency of the primary market in government securities has been improving in recent years. Since September 2006, the Ministry of Finance has started to publish a yearly treasury bills and treasury bonds auction calendar. The calendar contains the information of dates, types of instruments and volume of each auction. The Bangladesh Bank (Central Bank) has also started to publish auction results on its website.

Table 6: Composition of government domestic debt in Bangladesh (Taka billion)

Fiscal year	National savings certificates	Treasury bills	Treasury bonds and NIBs	Total
2000	169.32	152.18	39.95	361.45
2001	211.71	179.07	42.09	432.87
2002	258.72	207.34	42.20	508.26
2003	258.87	200.78	43.34	502.99
2004	362.21	123.20	47.17	532.58
2005	366.20	167.52	14.21	547.93
2006	395.89	149.84	26.57	572.30
2007 (Feb.)	421.50	162.16	77.41	661.07

Note: Data are for the end of fiscal year, June 30, except for 2007.
NIB stands for National Investment Bonds.
Source: Bangladesh Bank

Key statistics of bond issues in Bangladesh appears in Table 7. Corporate bond markets in Bangladesh remain negligible in size. Bangladesh companies are insignificant players in the bond market, with outstanding debts accounting for only 0.2 percent of GDP. As such, the corporate bond market in Bangladesh is at a nascent stage with a shallow market. During 1988–2007, only 15 debentures were issued through public offerings. Many of these bonds were partially convertible into common stocks. The largest issue of corporate bond was made in 2007. It was a *mudaraba* perpetual bond with a size of Taka 3,000 million (Approx. US$ 43.5 million). It is an Islamic bond based on profit-sharing concept as interest is forbidden by Islam (Table 8). The nine debentures (bonds) are outstanding at the end of 2007. The corporate bond market faces significant constraints, but also has a potential because of an expected growth in bank and infrastructure bonds. It is expected that in view of the need to make large scale long-term investments especially for financing rapidly increasing infrastructural requirements, the availability of long-term funds for investment is a pre-requisite. In addition, 31 privately placed corporate bonds were approved by the SEC amounting to Taka 9,540 million during 1998 and 2007.

Table 7: Key statistics of bond issues in Bangladesh

Year	Number of Bonds Outstanding		Market Capitalization of Bonds (Million)		Transaction (Million)	
	Corporate	Govt.	In Taka	In US $	In Taka	In US$
1998	11	0	1,342	27.67	0.04	0.00
1999	12	0	777	15.09	0.01	0.00
2000	10	0	N.A	N.A	29.79	0.58
2001	9	0	766	15	6.96	0.13
2002	9	0	766	15	0.83	0.02
2003	8	0	517	9	0.01	0.00
2004	8	0	517	9	N.A	N.A
2005	8	18	12,165	185	9.55	0.15
2006	8	34	45,401	656	N.A	N.A
2007	9	61	127,887	1,864	1,215.13	17.61

Source: DSE, CSE and SEC reports.

Table 8: Issue of Corporate Debt Securities in Bangladesh (Taka million)

	Debt Securities	Year of Issue	Features	Size
1	17% Beximco Pharma Debenture	1988	20% Convertible	42
2	17% Beximco Limited Debenture	1989		60
3	17% Beximco Infusion Debenture	1992		45
4	17% Bangladesh Chemical Debenture	1993	20% Convertible	20
5	14% Beximco Synthetic Debenture	1993		375
6	14% Beximco Knitting Debenture	1994	20% Convertible	240
7	14% Beximco Fisheries Debenture	1994		120
8	15% Eastern Housing Debenture	1994	10% Convertible	810
9	14% Beximco Textile Debenture	1995		240
10	14% BD Zipper Debenture	1995	20% Convertible	40
11	14% Beximco Denim Debenture	1995		300
12	14% BD Luggage Debenture	1996	20% Convertible	150

13	14% Aramit Cement Debenture	1998	20% Convertible	112.5
14	14% BD Welding Electrodes Debentures	1999		20
15	IBBL Mudaraba Perpetual Bond	2007	Profit Sharing	3,000

Source: DSE, CSE and SEC reports.

(4) Constraints on development of bond market

The slow growth of the bond market in Bangladesh is attributed to a number of factors including the supply side constraint such as a lack of benchmark bonds, market distortions caused by the national savings scheme, a lack of interest from private companies in bond issue as a result of high costs, default of debentures in the past, and the general preference of investor in the equities rather than in bonds.

(i) 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.

(ii) National savings scheme is intended to encourage individual savings at high interest rate (Table 9). 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.

(iii) 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.

(iv) Unwillingness of many companies to meet the disclosure requirements for listings on the exchange has reduced the supply of corporate bonds.

(v) 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.

(vi) 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.

(vii) 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.

(viii) In Bangladesh, relatively high inflation prevailed in the past, which has caused potential investors shy in corporate securities' investment.

(ix) A weak regulations and market infrastructure hampers the development of an active bond market.

Table 9: Interest rate on savings products by source and maturity (June 2007)

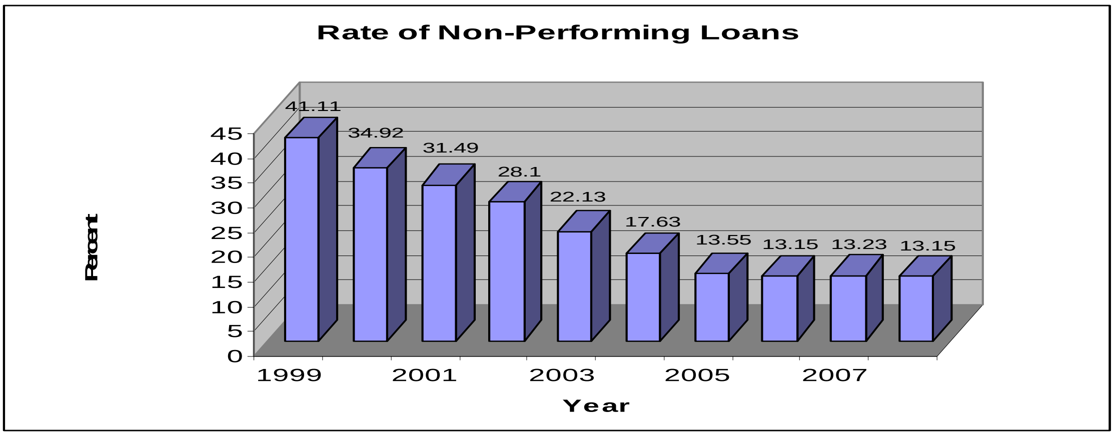
Source	3－6 months	6 months to 1year	3 years and above
Post office	—	—	11.5
National commercial banks	6.5－7.5	6.75－7.75	8－8.5
Specialized banks	5.75－7.25	6－7.5	6.75－8
Private banks	7－12.75	7.25－13	8－11.75
Foreign banks	3.75－12.5	4－12.25	4.5－11
National savings certificates	n.a	n.a	12

Note: The interest rate on national savings certificates is an average.
Source: Bangladesh Bank

(5) Corporate debt market

As mentioned above, bank loans are the major financial sources for companies. The spread between lending and deposit rates has been rather high in reflection of banking sector inefficiencies, in particular, high administrative costs and sizable non-performing loans (Figure 1). Bangladesh Bank is advising the banks to carefully assess borrowers' credit worthiness in order to improve the credit quality of the financial institutions. The debt market of Bangladesh is very small and corporate debt market is even much smaller. The dominance of banking sector in corporate finance implies that other sources of corporate debt instruments are underdeveloped. Bangladesh needs to develop alternative sources of finance other than bank loans by diversifying the debt instruments, inter alia, corporate bonds and asset backed securities. Otherwise, companies have little option in the choice of financing which is counteractive to the healthy development of financial market in Bangladesh. The government has to promote the corporate bond market by developing a comprehensive set of guidelines on issuing bonds and debentures under the direction of the SEC. The government is also required to address high issuing costs, and create an environment conducive to the development of bonds by lowering the interest on national savings certificates. At the same time, companies have to realize the disclosure requirements for listings on the exchange if they wish to raise funds through corporate bonds.

Figure 1: Rate of Non-performing loans



Source: Bangladesh Bank. 2008 figure is at the end of March.

(6) Information asymmetry and interest rate

There exists a problem of information asymmetry in Bangladesh. Adequate assessment of default risk of borrowers is often affected by information asymmetry. There is little institutional framework to obtain client information that would enable the lenders to assess risks. As a consequence, it happens quite often that more credit worthy borrowers have to pay relatively higher interest and less credit worthy borrowers pay relatively lower interest on their loans. Previously, banks used to charge uniform interest rate to all borrowers irrespective of default risk. Later, banks, inter alia, the private banks began to assess credit worthiness of borrowers. Currently, under the directives of the Bangladesh Bank, all banks and non-bank financial institutions must assess the default risk of the borrowers through a given format (Appendix 1). Consequently, the lender can vary the interest rate up to 3 percent depending on the borrowers' default risk. However, there is little scope to verify client information. This problem intensifies as many firms do not comply with the accounting standards and the reliability of their accounts remains in question.

In recent years, many banks, inter alia, the private and foreign bank, are pursuing relationship banking. This reduces the information asymmetry between the borrowers and the bank. In many countries, bank can charge lower interest to their borrowers because of relationship banking. This implies a lower cost of capital for the borrowing firms. But, there is no evidence of lower cost of capital in Bangladesh due to relationship banking. Based on a sample of 174 companies listed on the Dhaka Stock Exchange (DSE), Ahmed and Uchida (2005) point out that relationship banking appears to provide better access to credit. However, it does not reduce the interest expense to the borrowers, rather their cost of borrowing is higher.

Information asymmetry has remained a major problem for small and medium enterprises (SMEs). These firms often have high earnings volatility. Coupled with this, information asymmetry problem deters the financial institutions to make adequate assessment of credit risk. As a consequence, the SMEs often have lower access to credit.

(6) Relevant capital market infrastructure

Central depository system

A central depository system (CDS) has been created for all securities. The Central Depository Bangladesh Limited (CDBL) was set up in 2000 as the sole depository system in Bangladesh. It facilitates electronic book entry, recording and maintaining securities accounts, and transfer of securities. Currently, the CDBL is owned by 80 institutions including commercial banks, insurance companies, stock exchanges, investment companies, listed companies, and the Asian Development Bank. In 1997, ADB approved the 'Capital Market Development Program Loan for Bangladesh', one element of which was the establishment of an automated CDS. Under the old paper-based delivery system, settlement and transfer procedures were handled manually and plagued by lengthy delays, risks of damage, loss, forgeries, duplication, and wasteful investment in time and capital. Subsequently in 2003, ADB further assisted the development of CDBL by equity participation. The broader policy issues of CDBL are guided by a board of directors consisting of 13 members. Since the commencement of its operations, the majority of listed companies dematerialized their shares to get its service. In addition, it facilitates secondary market trading of treasury bills and government bonds. The operations of CDBL are monitored by the SEC.

Clearing and Settlement System

Although a central depository system has been established, Bangladesh has yet to establish modern 'Clearing and Settlement System'. Presently, Bangladesh uses a manual payment system for securities transactions, which prevents settlement on a delivery-versus-payment basis. Since clearing and settlement system is an essential infrastructure for the sound development of bond markets, Bangladesh needs to be establish modern 'Clearing and Settlement System' to facilitate the smooth flow of transactions in the primary and secondary markets, to strengthen investor confidence, to stimulate market growth, and to limit exposure to systemic risk.

(8) Bond /debenture issuance procedure

The SEC is the approving authority for issuance of bond and debenture. In case the bond is to be issued by financial institutions, not only an approval from the SEC, but also from Bangladesh Bank is required. If the bond is issued as a public offer, approval from the stock exchange is also required. The SEC has not yet finalized the specific 'Bond Issue Rules and Regulations', although the draft Rules has already been prepared with the assistance of ADB. However, right now the bond issue is primarily carried out on the basis of ‘Public Issue Rules 2006’ and ‘Asset Backed Security Issue Rules 2004’. If it is a public issue, it should be governed as per ‘Public Issue Rules 2006’ and credit rating is mandatory for such an issue. For debt issue, an issuer shall appoint issue manager(s) registered with the SEC for the purpose of making the public offering/private placement. The public company issuing bond/debenture shall appoint a ‘Bond/Debenture Trustee’ to protect the interest of debenture/bond holders. The ‘Bond/Debenture Trustee’ shall be a bank, a financial institution, an insurance company or any other entity registered with the Commission to act as Trustee. ‘Deed for Engagement of Trustee’ needs to be approved from the SEC as well. There are certain eligible criteria stipulated in the ‘Asset Backed Security Issue Rules 2004’ to act as a Trustee among others:

1. Minimum paid up capital has to be Taka 10.00 million;
2. Minimum net worth has to be Taka 8.0 million;
3. No substantial relationship should exist with Trustee and its Directors with an issuer and/or its sister concern;
4. No director should be a defaulter on loans; and
5. Good reputation in the market should prevail.

Criteria considered by SEC for approval

1. It is preferred that companies issue IPO first, then bond/debenture;
2. Risk factors and management’s perception about the risks has to be clearly stated and should be justifiable to the SEC;
3. The prospectus shall show how the net proceeds of the offerings shall be used, indicating the amount to be used for each purpose. The SEC should be convinced that financing need and planning is justifiable;
4. Comprehensive analysis of the business;
5. Plan of operation and discussion of financial condition;
6. Financial projection and justification of assumption;
7. Structure and terms and conditions of the debt securities;
8. Capital increase history;
9. Utilization of resources over the past years; and
10. Historical and projected profitability, liquidity, operating and debt service ratios.

2. Credit Rating agencies in Bangladesh

(1) General features of credit rating agencies

There are two domestic credit rating agencies and no international or regional credit rating agencies exist in Bangladesh. The first, Credit Rating Information and Services Limited (CRISL), was set up in 1995 and got license from the Securities and Exchange Commission to operate as a rating agency in 2002. It is a joint venture of Malaysia Berhad (RAM), JCR-VIS Credit Rating Company of Pakistan, and a few financial institutions and professionals of Bangladesh. CRISL receives technical support from RAM and JCR-VIS and also undertakes rating assignments jointly with support of the

JV partners, if required. The second, the Credit Rating Agency of Bangladesh (CRAB), was established in 2003. CRAB received licence in 2004 from SEC under 'Credit Rating Companies Rules 1996'. CRAB formally launched its operation in April 2004. The sponsors are some leading personalities and professional in the private sector and institutions of the country. CRAB has technical collaboration with ICRA Limited of India, which is a subsidiary of Moody's Investors Service. ICRA is one of the largest rating agencies in Asia. Table 10 shows the '**Profiles of Credit Rating Agencies in Bangladesh'.**

Both CRISL and CRAB were recognized by Bangladesh Bank as the External Credit Assessment Institution (ECAI) to offer its services to the banking community for banking client rating. The majority of credit rating in Bangladesh is entity rating and instrument rating is relatively scarce due to the limited number of bond and other issues.

Both CRISL and CRAB offer various rating services covering the following:

Corporate/ entity rating for direct listing or for IPO at premium, bank/ financial institution rating, insurance (general & life) rating, bank counter party rating, bank loan exposure/facility rating, rating of the structured products such as zero coupon bonds, mortgage backed, and asset backed securities, debentures, preference share financings, subordinated debt, convertible bonds, guarantee products, securitized transactions, project financing ratings, micro finance rating, MFI- social impact rating, educational institution rating, and corporate governance rating.

Table 10: Profiles of Credit Rating Agencies in Bangladesh

	CRAB	**CRISL**
1 Year of establishment	**2003**	**1995**
2 status/nature	Independent Bangladesh agency	Associate of RAM and JCR-VIS
3 Ownership structure	Professionals and institutions	RAM, JCR-VIS and local investors
4 Covered issues	164 issues and issuers covering financial and corporate sectors (March 2009)	181 rating assignments covering financial and corporate sectors (March 2009)
5 Major activities		
①credit ratings and risk assessment;	Rating responsible for **Local scale** (local currency) under four categories: long-term, short-term, fixed deposit, and issuer ratings	
-Rating schemes	①Debt instruments; ②Issuer Rating; ③Structured finance; ④Equity rating (initial public offering and right offering); ⑤Corporate governance & stakeholder value addition rating; ⑥ Insurance company rating/claims paying ability rating; ⑦Mutual funds schemes rating; ⑧Clientele rating for banks/financial institutions; ⑨Project finance; ⑩Microfinance institution	①Debt instruments; ②Issuer Rating; ③Structured finance; ④Equity rating (initial public offering and right offering); ⑤Bank counter party rating ; ⑥ Insurance company rating/ claims paying ability rating; ⑦MFI rating; ⑧Hospital rating; ⑨Educational institution rating; ⑩Corporate governance rating; ⑪Project financing rating; ⑫Bank loan exposure/Facility rating

	rating; ⑪MFI- social impact rating	
-clients/ assigned bodies	Corporate Sector Companies; Banks/Financial institutions; Insurance companies; Infrastructure sector companies; services; Micro finance institutions; Non-banking finance companies; Educational institutions	Manufacturing firms; Banks/ Financial institutions; Insurance companies; Infrastructure sector companies; Hospitals; Micro finance institutions; Non-bank finance companies; Educational institutions
- others	Grading service; Credit assessment of large, medium and small scale units for obtaining specific lines of credit from commercial banks, financial institutions and financial services companies	Training services in such areas as banks and financial institution analysis, and risk management for the development of Bangladesh financial sector
②Economic / industrial researches	responsible by CRAB	responsible by CRISL
③management advisory services	Consultancy and advisory services	Consultancy and advisory services
④Others	To act as trustees of any debentures, bonds, securities, etc.	Due diligence services & equity research for the general investors
6 Rating Methodology	Factors considered:	Factors considered:
	Companies' future cash generation capacity taking into account of the following:	Sector specific considerations and a large number of qualitative and quantitative factors such as
	Industry characteristics; Competitive position of the issuer; Operational efficiency; Management quality; Commitment to new projects and other associate companies; Future funding policies of the issuer	Historic and projected financials, Level of profitability, Capacity utilization, Capital expenditure need, Cash flow adequacy, Debt servicing capacity with appropriate weight to both qualitative and quantitative factors
7 Mapping (long-term and short-term)	①Long-term (AAA～BBB3) ; Short-term(ST-1～ST-3) ②Long-term(BB1～C); Short-term(ST-4～ST-5) ③Long-term(D); Short-term(ST-6)	①Long-term (AAA～BBB-) ; Short-term(ST-1～ST-3) ②Long-term(BB+～C-); Short-term(ST-4～ST-5) ③Long-term(D); Short-term(ST-6)
8 Rating Outputs	Transition study (2006-2008)	Transition study (2002-2008)
9 Major focus on rating and analysis	Assess future cash generation capability and debt servicing ability of the issuer. An analysis of operational efficiency, liquidity position, and financial flexibility is also focused at in evaluating the strengths and weaknesses of the company	Assess future cash generation capability and debt servicing ability of the issuer. An in-depth study of the sector as well as an evaluation of the strengths and weaknesses of the company

10 Special features	Technical cooperation from ICRA limited of India in local credit ratings including training Independent Rating Committee of professionals from former officials of SEC, Bangladesh Bank, etc.	Technical support from RAM and JCR-VIS and also to undertake rating assignments jointly with support of the JV partners, if required Rating Committee consists of senior professionals of CRISL and at least one person having sector knowledge

Sources: CRAB, CRISL

(2) Rating Requirement in Bangladesh

The Securities & Exchange Commission (SEC) is the main body responsible for issuing 'Rules for credit rating'. In addition to SEC, Bangladesh Bank and Chief Controller of Insurance also issued rules for credit rating in their respective jurisdiction. Since 1996, a number of rules have been issued:

i) The Credit Rating Agencies Rules 1996 issued by the SEC require that the following instruments be rated prior to making issuance and that the information on rating be incorporated in the prospectus of offer documents:
   a. Public offering of all debt instruments: bond, debenture, commercial paper, structured finance (asset/mortgage backed securities) and preference shares
   b. Public issue of shares at a premium

ii) SEC through its Securities and Exchange (rights issue) Rules, 2006 require rating of the followings:
   a. All rights issue at premium

iii) The SEC rules 2004 (asset backed security issue) require the credit rating of asset pools to be securitized with optional requirements of credit rating of the originator.

iv) Bangladesh Bank through its circulars require mandatory credit rating for the followings:
   a. All scheduled banks on an annual basis
   b. All financial institutions in case of IPO

v) Chief Controller of Insurance through its circulars require mandatory credit rating for the followings:
   a. All general insurance companies on an annual basis
   b. All life insurance companies on biennial basis

vi) Bank client/ facility rating under Basel II: under standardized approach, risk weights to be assigned based on the rating of ECAI otherwise 125% for unrated corporate.

(3) **Rating notches**

CRAB uses 22 notches which are in line with S&P and Moody's. On the other hand, CRISL uses 26 notches. Demonstration of alignment with international ratings of S&P and Moody's is presented in Table 11:

Table 11: Rating alignment

Notches	CRAB	CRISL	S&P	Moody's
1	AAA	AAA	AAA	Aaa
2	AA1	AA+	AA+	Aa1
3	AA2	AA	AA	Aa2
4	AA3	AA-	AA-	Aa3
5	A1	A+	A+	A1
6	A2	A	A	A2
7	A3	A-	A-	A3
8	BBB1	BBB+	BBB+	Baa1
9	BBB2	BBB	BBB	Baa2
10	BBB3	BBB-	BBB-	Baa3
11	BB1	BB+	BB+	Ba1
12	BB2	BB	BB	Ba2
13	BB3	BB-	BB-	Ba3
14	B1	B+	B+	B1
15	B2	B	B	B2
16	B3	B-	B-	B3
17	CCC1	CCC+	CCC+	Caa1
18	CCC2	CCC	CCC	Caa2
19	CCC3	CCC-	CCC-	Caa3
20	CC	CC+	CC	Ca
21	C	CC	C	C
22	D	CC-	SD/D	-
23		C+		
24		C		
25		C-		
26		D		

(4) Rating methodologies

The rating methodologies used by CRAB for ratings of different types of instruments and entities/issuers have been developed in collaboration with ICRA. In preparing the methodologies, the rating criteria used by the leading international rating agencies have been taken into account. Inputs have also been taken from local experts to incorporate the dynamics of the domestic practices and parameters. The methodologies are subject to evaluation and validity test on a regular basis. CRAB has developed a standardized rating methodology for different instruments and entities. The methodologies have been developed considering all the relevant factors impacting on the future cash generation capacity of the issuers. These factors include: industry characteristics & regulations, competitive position of the issuer, operational efficiency, management quality, commitment to new projects, securities and relationship, strength of associate companies, and funding policies of the issuer. A detailed analysis of the past financial statements is also made to assess the actual business performance. Analysis considering the estimated future earnings under various sensitivity scenarios are drawn up and evaluated against the future obligations that require servicing over the tenure of the instrument being rated. CRAB rating methodology intends to assess the relative comfort level of the issuers to service the obligations and this is reflected in the rating of a debt instrument. In case of equity instruments the rating reflects the future earning capabilities with reference to the resilience to perform in adverse situations.

On the other hand, CRISL has developed economic sector wise rating methodology which is applied in the rating process. The methodologies have been designed after due consideration to the specific insights of each sector with appropriate weight to both qualitative and quantitative factors of each sector. CRISL rating methodologies are in compliant with the IOSCO Code of Conduct published by International Organization of Securities Commission applicable for the global and local rating agencies. CRISL has so far developed and published its rating methodology covering the following sectors:

a. Rating methodology for bank and financial institutions
b. Rating methodology for microfinance institutions
c. Rating methodology for manufacturing industry
d. Rating methodology for general insurance
e. Rating methodology for life insurance
f. Rating methodology for asset backed securities
g. Rating methodology for bank loan/facility rating
h. Rating methodology for trading concerns
i. Rating methodology for telecommunication

Both rating agencies' methodologies cover banks, financial institutions, micro finance institutions, insurance sector (both general and life), corporate sector, mortgage back securitization, asset backed securitization, zero coupon bonds, etc. In the following diagram, CRAB's rating methodology for bank and corporate sectors is depicted (Figure 2 & 3):

Figure 2: CRAB's bank rating methodology

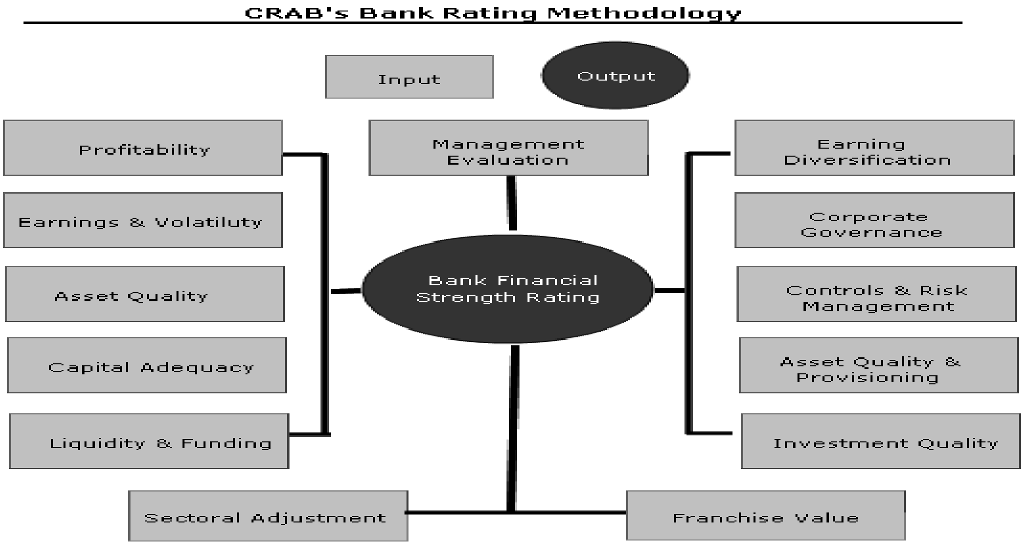
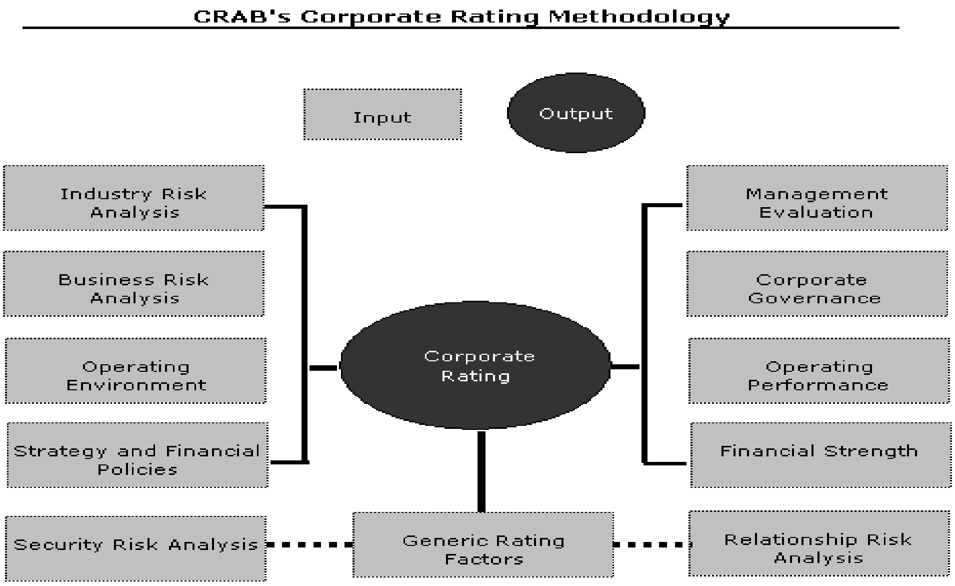


Figure 3: CRAB's corporate rating methodology



(5) Rating process (CRAB)

Rating is an interactive process with a prospective approach. It involves a series of steps. The main steps are described as follows:

(a) Rating request:

Ratings are usually initiated on receipt of a formal request (or mandate) from the prospective issuer. The mandate spells out the terms and conditions of the rating assignment. This contains the rights and obligations of the concerned parties in the context of the rating assignment.

(b) Appointment of rating team:

The rating team usually consists of two members. The composition of the team is based on the expertise and skills required for evaluating the business of the issuer. The team is usually led by the lead analyst with adequate knowledge of the relevant industry/instrument to be rated.

(c) Chief rating officer:

The chief rating officer would be responsible for maintaining the quality and integrity of the rating process and the rating decisions. He would constitute the rating team, issue directions and guidance to the analysts on policy matters; convene the Rating Committee meetings, co-ordinate with the Rating Committee members and the analysts. He would hold the overall charge of the rating function of the credit rating agency.

(d) Role of the lead analyst:

・The lead analyst shall arrange to finalize the rating report and send the same to the Rating Committee members.

・The lead analyst shall arrange to make a presentation before the Rating Committee.

・The lead analyst will make sure that all the relevant and material issues that may have an impact on the credit quality of the issuer (including, but not limited to those which are related to the program being rated) are presented before the Rating Committee for discussion.

・Once the rating is decided, the lead analyst will prepare the final press release. The lead analyst will ensure communication of the rating decision to the issuer and initiate all the necessary actions consequent to the reaction of the issuer depending on the circumstances.

(e) Information requirements:

Issuers are provided with a list of information requirements and broad framework for discussions. These requirements are derived from the experience of the issuers business and broadly conform to all the aspects, which have a bearing on the Rating.

(f) Secondary information:

CRAB draws on the secondary sources of information including its own in-house research and information obtained through meetings with the issuers' bankers, auditors, customers and suppliers among many other relevant market participants. CRAB also has a panel of industry experts who provide guidance on specific issues to the rating team. The secondary sources generally provide data and trends including changes in industry structure, sector outlook, global trends and government policies, etc. for the industry.

(g) Management meetings and plant visits:

Rating involves assessment of number of qualitative factors with a view to estimate the future earning prospects of the issuer. This requires intensive interactions with the issuers' management specifically with a view to understanding the business plans, future outlook, competitive position and funding policies, etc. Plant visits facilitate understanding of the production process, assess the state of equipment, technology and main facilities, evaluate the quality of technical personnel and form an opinion on the key variables that influence level, quality and cost of production. These visits also help in assessing the progress of projects under implementation.

(h) Other meetings:

The CRAB analyst team may also decide to meet the auditors (accounting policies followed, quality of internal controls, standard of disclosures, etc.), bankers/lenders (relationship, reputation, dealings in the past in respect of timeliness of servicing obligations) lawyers (if there are major litigations pending which may have serious impact on credit quality), trade union leaders (if industrial relations is a sensitive issue), key functional executives as well as a few investors, customers and suppliers, depending upon the circumstances to get a direct feedback from different stakeholder.

(i) Meeting with the issuers' CEO/CFO:

This would be a very important meeting (usually, the last meeting) when the rating team would discuss all the critical issues/findings that may impact the rating decision with the CEO/CFO of the issuer. The purpose of the meeting is to get the views and reactions of the senior management of the issuer on all the critical issues/findings that are likely to have an impact on the rating decision. The reaction of the senior management should be incorporated in the rating report. The analyst team, if they so desire, may give their comments alongside each of such reactions.

(j) Rating committee meeting:

The authority for assigning Ratings is vested in the Rating Committee of CRAB. The Rating reports are sent by the analyst team in advance to the Rating Committee members. The rating reports are prepared under the supervisions of the CRO. However, the Rating analysts are encouraged to express their views freely in the Rating reports. While the CEO/CRO of CRAB is entitled to provide guidance, advice and suggestions (irrespective of whether solicited or not by the analyst team), it is entirely at the discretion of the analyst team whether to incorporate them in their report or not. A presentation about the issuers business and the management is made by the rating team to the Rating Committee at the meeting. All the key issues are identified and discussed at length during the meetings and all relevant issues, which influence the rating, are considered. Finally, a rating is assigned either by a consensus or by majority votes.

(k) Surveillance:

The ratings may be upgraded, downgraded or retained after the surveillance. The CRO/CEO, at their sole discretion, may give one opportunity to the issuer to represent his case if he is not satisfied with the rating decision after the surveillance process. However, the issuer would not have any option of not accepting the rating after the surveillance.

(6) Rating history

CRAB performed 164 rating assignments from 2004 to 2009 (March) whereas CRISL conducted 181 assignments from 2004 to 2008. Industry-wise year on year breakdown of ratings are given in Figure 4. It is noted that the majority of ratings of both local credit rating agencies were conducted for the banks and insurance companies due to the mandatory surveillance rating on a regular basis. As of March 2009, 45 debentures, 11 bonds, 95 entity (issuer), 2 preference shares, 10 securitization transaction including first ever micro credit securitization transactions in the world and 1 guarantee instruments (see exhibit 30 below) were rated by CRAB (Figure 5). Rating example by CRAB is presented at appendix 2.

Figure 4: Industry wise rating history of CRAB and CRISL

CRAB Rating History : By Industry Type

Industry/ Year	2004	2005	2006	2007	2008	2009*	Total
Bank	1	1	1	17	17	7	44
FI			5	7	12	1	25
Insurance				10	18	7	35
Textile	1	1	2	3	4	1	12
Service	1	3	1	3	1		9
Engineering	1	2	1	3	1		8
Agriculture			1	1	1		3
Coal			1				1
Gas					1		1
Infrastructure		1					1
Jute					1		1
Media	1						1
MFI			1	1	2		4
Pharmeceuticals		1	1				2
Power				2	3	1	6
Real Estate	1		1	2			4
Ship Building					1		1
Telecom				2	2	2	6
Total	6	9	15	51	64	19	164

* Up to March 2009

CRISL Rating History : By Industry Type

Industry/ Year	2004	2005	2006	2007	2008	2009*	Total
Bank	5	9	14	30	16		74
Ceramic					1		1
Leasing	3	9	10	5	2		29
Debt Instrument	3		1	1	1		6
Insurance	2	4		10	22		38
Textile	1	1		1	1		4
NGO		4					4
Paint/Chemical/Cosmetic		2		1			3
Power		1	2	5	1		9
Housing			1	1	1		3
Steel			1		1		2
Food				1			1
ICT			1				1
Jute				1			1
Oil				2			2
Hospital				1			1
Pvt. Container Port					1		1
Plastic					1		1
Total	14	30	30	59	48		181

* Data not available

Source: CRAB, CRISL

Figure 5: CRAB's rating history by type

CRAB Rating History : By Rating Type

Year	2004	2005	2006	2007	2008	2009*	Total
Debenture	5	4	8	15	10	3	45
Bond	-	1	1	1	7	1	11
Entity	1	2	3	32	43	14	95
Preference Share	-	1	1	-	-	-	2
Securitisation	-	1	2	3	4	-	10
Guarantee	-	-	-	-	-	1	1
Total	**6**	**9**	**15**	**51**	**64**	**19**	**164**

* Up to March 2009

(7) Transition matrix

Total number of rating assignments as well as rating history in Bangladesh is not significant for constructing transition matrix. Moreover, except banks and insurances, not all the ratings of the entity or instrument are subjected to surveillance rating by the law as well as by market force. However, under Basel II regime, as an ECAI recognized by the Bangladesh Bank ratings to be assigned by the rating agencies need to be monitored in order to capture the default transition which will eventually help the rating agencies to construct transition matrix. At present mainly banks, insurance and some instruments are under surveillance rating.

Transition matrix of CRAB and CRISL is presented in Figure 6. CRAB considers ratings from 2006 to 2008 whereas CRISL considers from 2002 to 2008. CRAB upgraded 10%, downgraded 3% and 86% remain stable, on the other hand CRISL upgraded 60%, downgraded 9% and 21% remain stable.

Figure 6: Transition matrix of CRAB & CRISL

(%)

CRAB Transition Matrix	AAA	AA	A	BBB	BB	B	CCC	CC	C	D
AAA	100.00	-	-	-	-	-	-	-	-	-
AA	-	87.50	12.50	-	-	-	-	-	-	-
A	-	12.50	87.50	-	-	-	-	-	-	-
BBB	-	-	16.67	83.33	-	-	-	-	-	-
BB	-	-	-	25.00	75.00	-	-	-	-	-
B	-	-	-	-	-	100.00	-	-	-	-
CCC	-	-	-	-	-	-	-	-	-	-
CC	-	-	-	-	-	-	-	-	-	-
C	-	-	-	-	-	-	-	-	-	-
D	-	-	-	-	-	-	-	-	-	-

CRISL RATING TRANSITION

	Total	AAA	AA	A	BBB	BB	B	CCC	CC	C	D
AAA	3	100.00%	-	-	-	-	-	-			
AA	13		100.00%								
A	59		3.30%	96.70%							
BBB	33			18.18%	81.82%						
BB	12				50.00%	41.67%	8.33%				
B	4					25.00%	75.00%				
CCC	0							-			
CC	0								-		
C	0									-	
D	1										100.00%

Source: CRAB, CRISL

(8) Differences of domestic credit rating agencies and major foreign credit rating agencies

Bangladesh companies have not issued bonds in the international markets. As such, it is difficult to compare the locally rated entities and issues with those of international ratings. The rating exercise in Bangladesh is at its early stage. Maturity of a rating agency depends on, among others, length of service of a rating agency, number of assignment, rating exercise over the cycle, etc. Both rating agencies are associated with international rating agencies for the development of rating methodologies and framework. In addition, Association of Credit Rating Agencies in Asia also plays pro active role in harmonizing rating and its methodologies among the rating agencies in Asia.

(9) Credit rating agencies and Basel II

Bangladesh Bank introduced BASEL II capital adequacy assessment for banks in January 2009 as part of its efforts to encourage banks to systematically evaluate material risks to their capital bases. It is understood that due to Basel II compliance, capital requirement of most of the bank would shoot up. Therefore, banks, in particular undercapitalized ones, would take necessary steps and measures to manage its capital adequacy level through capital planning as well as enhancing the risk control mechanism of its operation. As such, there is a possibility of issuance of Tier II and Tier III bond in order to meet the capital requirement. On the other hand, almost all the counterparty of the banks are now unrated. Due to capital pressure, a certain portion of corporate body would come under rating surveillance, through which banks would try to minimize its capital requirement. In the medium to long term, the health of the banking sector as a whole would be more prudent under Basel II regime compared to Basel I regime. However, during the process, a few individual banks may face problem and difficulty, but banking industry as a whole would benefit eventually.

In April 2009, Bangladesh Bank accredited CRAB as an External Credit Assessment Institution (ECAI). Under the standardized approach for calculating risk weighted assets against credit risk, the credit rating is to be determined on the basis of risk profile assessed by the ECAIs. Banks will use the ratings of the ECAIs and corresponding risk weight for calculating RWA for credit risk under the standardized approach (Table 12). Bangladesh Bank has also recognized CRISL as ECAI to assess credit risk under "Risk Based Capital Adequacy for Banks" in line with Basel-II framework.

Table 12: Risk weights of corporate claims under Basel II

CLAIMS ON CORPORATE (excluding equity exposures)	Bangladesh Bank Rating Grade	Equivalent CRAB Rating	Risk Weight %
	1	AAA	20
	2	AA1, AA2	50
	3,4	AA3, A1, A2, A3, BBB1, BBB2, BBB3	100
	5,6	BB1, BB2, BB3, B1, B2, B3, CCC1, CCC2, CCC3, CC, C, D	150
	Unrated	—	125

Source: CRAB

3. Problems to be solved and the outlook of Bangladeshi capital market

(1) Constraints and actions for development of corporate financial markets

There are a number of constraints to the development of corporate financial markets in Bangladesh. The debt securities market is still at an incipient stage. It is characterized by a limited supply of debt instruments, particularly long-term ones. As a result, the credible benchmark for long-term bonds or debentures does not exist. The market is illiquid and trading is inactive. It is hindered by the relatively high interest rate bearing risk-free national savings scheme, albeit interest rate has been reduced to some extent in recent years. Moreover, the procedure for issue of bond is cumbersome and costly, which becomes a deterrent to the development of corporate bond market. Lastly, the investor base has to be expanded in parallel with an appropriate investor education. Recommended actions to be undertaken for developing the corporate financial markets are indicated below:

(a) To expand the government debt securities market to provide benchmark bonds and yields, to improve the efficiency and transparency of the secondary market, and enhance its liquidity;

(b) To develop market infrastructure and an environment for the bond market by upgrading the depository, and clearing and settlement system, to develop money market, to improve legal and regulatory framework, and to strengthen the credit rating agency;

(c) To reform the national savings scheme by adjusting its returns to market rates and targeting only at small investors;

(d) To broaden and diversify the investor base by promoting pension sector reform, to strengthen the insurance sector, to attract foreign investors, and to implement an investor education program; and

(e) To promote the corporate bond market by revising the SEC guidelines on issuance of bonds and debentures, further reducing issuing costs, and by tapping potential new issuers such as banks for Tier 2 capital.

(2) Problems to be solved for credit rating in Bangladesh

The history of corporate debt issue and credit rating in Bangladesh is rather short. As such, in order to develop an active credit rating it is essential to expand the corporate debt market and strengthen the credit rating agency. The possible solutions to the expansion of the corporate debt market are described under **'constraints and actions for development of corporate financial markets'** above**.**

To strengthen the local credit rating agencies, the following measures have to be taken. First, infrastructure resources such as sources, access, authentication, and warehousing of data, credibility of audit report, and sophisticated and advanced level web based software development has to be put in place. Second, availability of adequate human resources for rating profession is critical. Third, presence of international credit rating agency is deemed necessary to increase competition. It is expected that over the next few years domestic rating agencies would be able to overcome the major obstacles through improving its database system and providing adequate training to its professionals. But, it may take some more years before an international credit rating agency shows an interest in setting up an office in Bangladesh.

(3) Outlook and prospects for expanding the local debt markets and credit rating activities

In Bangladesh, debt markets have not been developed. Accordingly, credit rating activities have not been active. However, there is a need to develop the debt market to cater for increasing demand for funds, inter alia from banks, infrastructure projects and long-term industrial projects. The government has been working on developing the debt markets including issuing benchmark treasury bonds with maturities of 5, 10, 15, and 25 years.

Therefore, outlook for expanding local debt market and credit rating activities is promising. Banks, insurance companies and non-bank financial institutions are under the purview of rating. In addition, for any bond and/or debenture issues as well as public offerings with premium, rating is mandatory. From 2010 regulatory capital of banks as well as non-bank financial institutions would be calculated based on Basel II guideline. Since unrated corporations would be assigned 125% risk weight, it is expected that a number of bank clients would also come under the umbrella of rating. Moreover, banks would issue Tier II and Tier III bonds to meet its capital adequacy level and credit-worthy corporate clients would also issue bonds to meet its funding requirements. Notwithstanding the above, it would take many years before Asian regional bonds are introduced in the country.

References

Ahmed, S.U. and S. Uchida (2005), "*Impact of Relationship Banking on the Performance of Corporate Firms: A Comparison between Japan and Bangladesh*", Journal of Business and Economics, Vol.85, No. 1-2, PP-237-245.

Asian Development Bank (2004), "*Bangladesh Country Governance Assessment*." Manila.

——— (2007), "*Bangladesh Quarterly Economic Update*." September, Manila.

Balalle, N.B.S.B (2006), "*Reform of the National Savings Scheme in Bangladesh*." Study report sponsored by the International Development Association of the World Bank Group, Washington, DC.

Bangladesh Bank (2006), "*Annual Report 2005–2006",* Dhaka.

——— (2007a), "*Annual Report 2006–2007",* Dhaka.

——— (2007b), "*Monetary Policy Statement*." June. Dhaka.

——— (2007c), "*Monetary Policy Statement*." July. Dhaka.

Crimson Capital (2006), "*Bangladesh: Study on Development of the Bond Market for Mortgage Backed Securities (MBS)*." Study report sponsored by the International Finance Corporation of the World Bank Group, Washington, DC.

IMF (2006), "*Bangladesh: Fifth Review under the Three-Year Arrangement under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria, Extension of the Arrangement, and Rephrasing—Staff Report*." Washington, DC.

———. 2007. "Bangladesh: Statistical Appendix." IMF Country Report 07/229. Washington, DC.

INAFI (International Network of Alternative Financial Institutions) (2006), "*Harnessing Remittances for Economic Development of Bangladesh*." INAFI Bangladesh Working Paper Series, No. 1. Dhaka.

Islam, M.S. (2008) , "*An Examination of the Securities Markets in Bangladesh*", unpublished.

Islam, M.T. (2009), "*Preliminary Report-Bond Market Development-Bangladesh Perspective*", unpublished.

World Bank and IMF (2001), "*Developing Government Bond Markets: A Handbook"* .Washington, DC

Appendix 1

Risk Grade Scorecard

Borrower / Group:	Score	Risk Grade	
Industry Code:	95+	2	**Aggregate Score:** ________
	75-94	3	
Date of Grading:	65-74	4	
	55-64	5	
Date of Financials:	45-54	6	**Risk Grade:** ________
	35-44	7	
Completed by:	< 35	8	

Criteria	Weight	Parameter	Points	Actual	Points	Weighted Score (Points * Weight)
Gearing	**20%**					
The ratio of a borrower's *Total Debt to Tangible Net Worth.*		< 0.25	100			
		0.26 – 0.35	95			
		0.36 – 0.50	90			
		0.51 – 0.75	85			
		0.76 – 1.25	80			
		1.26 – 2.00	75			
All calculations should be based on annual financial statements of the borrower (audited preferred).		2.01 – 2.25	70			
		2.26 – 2.50	65			
		2.51 – 2.75	60			
		2.76 – 3.00	55			
		> 3.00	0			
Liquidity	**20%**	> 3.50	100			
The ratio of a borrower's *Current Assets to Current Liabilities*		3.00 – 3.49	95			
		2.75 – 2.99	90			
		2.50 – 2.74	85			
		2.00 – 2.49	80			
		1.50 – 1.99	75			
		1.10 – 1.49	70			
		0.90 – 1.09	65			
		0.80 – 0.89	60			
		0.70 – 0.79	55			
		< 0.70	0			
Profitability	**20%**	> 0.30	100			
The ratio of a borrower's *Operating Profit to Sales*. Operating Profit defined as Gross Profit minus all expenses.		0.25 - 0.29	95			
		0.20 - 0.25	85			
		0.15 - 0.19	80			
		0.10 - 0.14	75			
		0.05 - 0.09	70			
		0.02 - 0.04	65			
		0.0 - 0.01	50			
		< 0	0			
Business Outlook	**10%**	Exceptional	100			
A critical assessment of the medium term prospects of the borrower, taking into account the industry, market share and economic factors.		Favourable	90			
		Stable	80			
		Slightly Uncertain	70			
		Cause for Concern	0			

Account Conduct	**10%**	**Customer for more than 2 years, with no past dues and faultless record.** **Customer for more than 6 months up to 2 years with faultless behavior.** **New Account with known satisfactory dealings with other banks.** **Some late payments or bounced cheques, though always cleared in 15 days or less.** **Frequent past dues, irregular items or bounced cheques.**	**100** **90** **80** **75** **0**			

Criteria	Weight	Parameter	Points	Actual	Points	Weighted Score (Points * Weight)
Management The quality of management based on the aggregate number of years that the Senior Management Team (top 5 executives) has been in the industry.	**5%**	**> 30 years** **25 – 30 years** **20 – 24 years** **15 – 19 years** **10 – 14 years** **< 10 years or any succession issues or other management weaknesses are identified.**	**100** **90** **80** **75** **65** **0**			
Personal Deposits The extent to which the bank maintains a personal banking relationship with the key business sponsors/principals.	**5%**	**All personal accounts are maintained in the bank, with significant deposits.** **Principals maintain some accounts, but have relationship with other banks.** **No relationship**	**100** **75** **0**			
Age of Business The number of years the borrower has been engaged in the primary line of business.	**5%**	**> 25 years** **20 – 25 years** **15 – 20 years** **10 – 15 years** **5 – 10 years** **2 – 5 years** **< 2 years**	**100** **95** **85** **80** **75** **70** **0**			
Size of Business The size of the borrower's business measured by the most recent year's total sales. Preferably based on audited financial statements.	**5%**	**Sales in BDT Millions** **> 1,000** **750 – 1,000** **500 – 750** **250 – 500** **100 – 250** **50 – 100** **25 – 50** **< 25**	 **100** **95** **90** **85** **80** **75** **70** **0**			

CRAB Ratings STRUCTURED FINANCE (SF)

SUBORDINATED CONVERTIBLE BOND UPTO BDT 3,000.00 MILLION AS TIER II CAPITAL BY BRAC BANK LIMITED

Bond Rating

Rating Award	: **AA_3**
Date of Rating	: 12 April 2009
Validity Date	: 1 (one) year

Entity Ratings

Rating Outstanding (12 April 2009)

Long Term	: **AA_2**
Short Term	: **ST-2**
Validity	: 1 (one) year

Previous Rating

	2008	2007
Long Term	: **AA_2**	**AA_3**
Short Term	: **ST-2**	**ST-2**

Analyst:

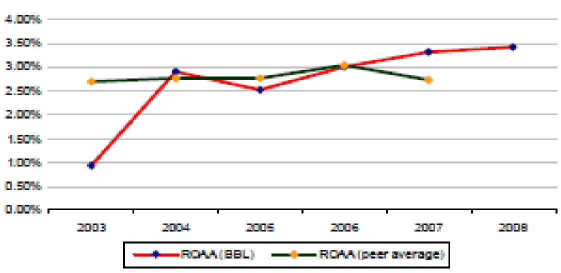
Nur Elahee Molla

Financial Analyst
nur_elahee@crab.com.bd

Financial Highlights

BDT in Million

	2008	2007
Loans & Advances	52,676.72	32,461.10
Non Performing Loan	2,473.01	1,444.78
Deposits	58,006.89	37,368.41
Investment	8,245.37	4,996.86
Net Interest Income	3,156.01	2,062.11
Non Interest Income	2,880.17	1,481.04
Net Profit Before Tax	2,023.45	1,264.34
ROAA (Before Tax)	3.41	3.31
Net Interest Margin	7.13	7.25
Capital Adequacy Ratio	12.76	12.28
Gross NPL Ratio	4.69	4.45
Net NPL Ratio	0.66	1.90
Deposit Lent Out Ratio	90.81	86.87



RATIONALE:

Credit Rating Agency of Bangladesh (CRAB) Limited has assigned **AA_3** (Pronounced Double A Three) to the proposed issuance of subordinated convertible bonds (Upto BDT 3,000.00 million) as Tier II capital by BRAC Bank Limited (hereafter called BBL).

Bond Instruments rated **AA_3** belonged to '**High safety**' cohort. In CRAB's opinion, the structure as well as credit worthiness of BBL allows for timely payments of bondholders obligation at par on or before maturity. The risk factors are modest and may vary slightly. The protective factors are strong and the prospect of timely payment of principal and interest as per terms under adverse circumstances, as may be visualized, differs from AAA only marginally. The bond under rated is generally the issuer's earning power that remains the primary sources of repayment.

The coupon of the bond is linked with 182 Days T-Bill which to some extent captures the variability of interest rate movements therefore minimizes the interest rate risk of the bondholders. The semiannual interest payment will reduce the re-investment risk of the bond holder. The holding of the issue to maturity will eliminate the liquidity risk. The option of the bondholders for either full repayment of the Face Value (principal amount) of the bond or convert 25% of the Face Value of the Bond at a pre-determined Conversion Strike Price into the common shares of BRAC Bank Limited eliminates the risk to the bondholders from the conversion calculations.

CRAB also assigned '**AA_2**' rating in the Long Term and 'ST-1' in the Short Term to BRAC Bank Limited. Commercial Banks rated '**AA_2**' rated in the long term belong to 'Extremely Strong Capacity & Very High Quality cohort. Banks rated '**AA_2**' have very strong capacity to meet their financial commitments. Commercial Banks rated '**ST–2**' in the short term are considered to have strong capacity for timely repayment.