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Capital Market Development: Asian Experiences

Message

THE 1997 Asian financial crisis points to the fact that weaknesses in the financial systems and free capital mobility have been crucial in aggravating and deepening the predicament. All the crisis-stricken countries had opened their market for free inflows of short-term funds and allowed foreign borrowing. It is well-known that the abolition of capital controls has often been followed by a large inflow of capital. Moreover, this inflow has typically been disproportionate in the form of short-term capital. As the crisis developed, domestic financial institutions found themselves unable to borrow, or even to roll over maturing loans.

In 1996, Bangladesh capital market also witnessed the biggest ever boom and as a consequence speculative trading gripped the market. DSE all share price index reached an all time high to 3648 points with the inflow of short-term foreign portfolio investments. In the absence of pre-emptive regulatory brake in an over-heated market, the inevitable happened and the market crashed and in a span of just a few months the index plunged to 650 points. The SEC established in 1993 came to the rescue and started the process of consolidation. Fundamentals and rationalities replaced speculations and rumours. Regulations become more comprehensive and as a result market started behaving more rationally and accountability has been put in place.

We in the International Chamber of Commerce (ICC) Bangladesh, The world business organisation felt that through dialogues among the regulators, policymakers, capital market operators, financial institutions of the region, it is possible to identify the areas of mutual cooperation and avoid recurrence of such market disruption.

Keeping this in mind, Bangladesh National Committee of Paris-based ICC has organised a two-day "Regional Seminar on Capital Market Development: Asian Experiences" in Dhaka on September 27-28, 2005 which is the first of its kind arranged in Bangladesh. We are overwhelmed by the response from the regional regulatory commissions and stock market operators and other major stakeholders for accepting our invitation to attend the Seminar at a very short notice. We believe that the two-day Seminar will provide a forum for sharing regional experiences and contribute significantly in setting up strategies for a sustainable capital market development programme that will reduce dependency for capital on the banking sector.

We are thankful of all our distinguished Moderators, Guest Speakers from home and abroad, multilateral agencies, Government of Bangladesh, esteemed participants, sponsors, supporters, advertisers, business community as well as ICC Bangladesh Secretariat to make the Event a success.

Mahbubur Rahman
President, ICC- Bangladesh

Capital market transaction in regional emerging economies

RAJNIKANT PATEL

Emerging economies are in the investment radar of investors worldwide chasing new growth opportunities. There are many drivers of this phenomenon. High personal debt in U.S., near saturated levels of personal consumption in the West, ageing population in the West etc. Thought leaders world wide are recognizing that this century is going to be the Asia century.

The action is here in the emerging economies of Asia. China story has been told and retold and needs no repetition. Much is happening in this sub-continent as well.

In this context, I would like to touch upon the Indian experience. Indian Capital Markets have been doing exceptionally well. Since September 2003, when the bull ran started, our markets have more than doubled. Bombay Sensitive Index (SENSEX) is posting new heights and recently crossed the 8000 mark. In terms of market capitalization, India's market cap now stands around US $ 510 billion and has overtaken both Korea and Taiwan. In the regional sweepstakes, India is behind Australia, Hong Kong and Japan.

There is broad consensus that in the medium- and long-term, Indian story is going to strongly unfold. Indian economy is one of the fastest growing economies of the world and the stock market mirror this fundamental fact. Though relative valuations at PE multiple of around 16 make the Indian market fully priced (some will say expensively priced) if you factor in the projected growth of around 7% per annum, forward PE multiples look far more reasonable. Markets will typically upfront the economy, and as long as strong GDP growth and economic growth provide the underpinnings for a buoyant stock market, things are relatively safe.

Additionally, what is attracting foreign investors into India is the fact that the Indian markets are very clearly well regulated and have adopted over the years efficient trading, clearing and settlement processes comparable with the best in the world. I will like to touch upon a few of them.

The Indian equity market operates rolling settlements, with trades settled T+2. We have order driven markets, entirely screen based. The tick size of 5 paise (one-eight of a cent, yes, one-eighth of a cent) represents one of the finest (may be the finest spread) spreads in the world. T+1 is being discussed, and its introduction is awaiting reforms in banking settlement processes through RTGS (Real Time Gross Settlement).

Settlement risk issues have been addressed. Paper delivery is negligible and is as good as over. Electronic credit of dematerialized securities has meant that all the attendant problems of paper delivery delays, conflicting corporate action entitlements, fake/forged shares, etc. are all things of the past. The load on both exchange back office and broker back office has considerably been eased, with settlement through electronic security credits.

The Settlement Guarantee Funds of the Exchanges, though seldom resorted to, have improved considerably the confidence of the players in the integrity of the market. From August the markets have adopted upfront collection of margins (based on VaR). This is a big step indeed in eliminating default risks. Additionally, EVR and mark-to-market margins are collected at the end of the day. This has considerably enhanced the safety climate, particularly in the context of buoyant conditions and new heights.

Markets world over are integrated. India is no exception with larger and larger FII participation. Many of the leading Indian companies have their GDRs listed abroad, with the underlying equity listed on the Indian markets. The Vedanta group's shares were listed in London and is a pointer of things to come.

The Futures & Options markets have been very vibrant, with high level of investor and speculative interest in futures and specifically index futures. Options on individual stocks have seen rising participation, with NSE emerging as one of the largest players in the segment. The F&O market is till cash settled, and the regulator is addressing concerns relating to overnight risk. Towards this, the regulator is exploring ways and means to promote stock lending.

In terms of direct taxation, the Government of India introduced major changes in the last budget for capital gain calculations. Short term capital gains on shares (i.e. holding period of less than one year) attracts a low rate of 10% basic tax. Long-term capital gains arising out of transactions on stock exchanges attract no tax. Dividends are tax free in the hands of the recipients, making dividend yields attractive in as scenario of low interest yields that too taxable at the marginal rate of 33%.

Though India has been posting a high savings rate of 24%, only a small percentage of individual household savings have found their way into the capital markets (estimated at less than 1.5%). By and large individuals still seem to prefer the safety of bank deposits and high yielding government small savings programmes. However, with the withdrawal of tax benefits associated with some of these savings, and reduced interest yield on some of the small saving schemes, the relative attraction of the stock markets amongst the small savers is on the rise. Some of the investors are now taking the mutual fund route and are participating in high quality public issues of Public Sector disinvestments and other large offerings.

The mutual fund industry is still predominantly debt-oriented. It is estimated that the total assets under management of mutual funds in India is of the order of US $ 60 billion. Equity funds have been having exceptional years, with passive investment in index funds gaining popularity. Sectoral funds too have caught the fancy of investors, though by very definition they dilute the benefit of a broad based portfolio. More sophisticated offerings based on hedging have also made a beginning with more than passing interest from retail clients.

Markets are getting integrated. India imports more than US $ 140 million worth of gold every year and Indian private holding of gold is the largest in the world. Gold ETF is being discussed with the regulators and its launch will represent a significant watershed in the Indian capital markets.

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There is much happening in the sub-continent. A spirit of peace and cooperation is in the air. The governments are keen to increase trade and commerce. We have a very large market in the subcontinent and opening of trade between the countries will give a tremendous fillip to the economic growth.

I would like to conclude the speech with a significant event which happened during 2005. Indian Oil, a hydro-carbon major involved in refining and distribution of petroleum products, through Lanka IOC made a public issue in Sri Lanka which met with an overwhelming response. It is my wish and hope that we will see more of such regional cooperation in the capital markets of the sub-continent in the years to come.

Rajnikant Patel is Managing Director and CEO, Bombay Stock Exchange Ltd.

Significant milestones in the development of Bangladesh stock market

IMRAN RAHMAN

THE stock market of Bangladesh was born in the late 1950s with the establishment of the Dhaka Stock Exchange (DSE). In the early years, the market was characterised by a handful of listed companies, narrow shareholding base, and thin trading activity. Large manufacturing companies in the private sector met their capital needs mainly from banks and retained earnings. In certain sectors, like the jute industry, new entrepreneurs received generous support from the government in the form of land, machinery and subsidised finance under an innovative scheme aimed at jumpstarting the manufacturing base of our country.

The government of the day formed the Investment Corporation of Pakistan (later Investment Corporation of Bangladesh) with the aim of encouraging greater public participation in the stock market through mutual funds and investors' accounts. From the issuers' point of view, ICP was the first institutional investor and investment bank, offering bridge finance and underwriting.

Primary market activity was overseen, not to any great extent, by a government department under the ministry of finance, archaically named the Controller of Capital Issues, an institution which had little concept of investor protection and disclosure needs. Secondary market activity was the under the purview of the Dhaka Stock Exchange, basically playing the role of a self regulating authority.

However, development activity in the fledgling market was put on hold following the independence of Bangladesh. As a result of whole-scale nationalisation of private manufacturing industry, banks and financial institutions, large-scale private sector activity ground down to a halt and the stock market entered a period of dormancy.

The thaw started in the late nineteen seventies, with greater focus being put on private enterprise, albeit in a limited way. Some nationalised industries were returned to owners, or privatised, and licences were issued for private banks. The stock market started waking up. In the late 1980s, some good companies (such as Beximco Pharmaceutical and Apex Tannery) floated shares and bonds.

At that time, regulations governing primary market activity were somewhat sketchy, with cursory oversight by the Controller of Capital Issues. In many case, issuing companies carried out most of the requirements and tasks leading up to floating shares. The quality of disclosure was not effectively monitored by any credible third party. Investment banking functions and distribution of new issues were carried out by the lone ICB, a handful of financial institutions, but mainly by the large brokerage houses of Dhaka Stock Exchange. The distribution base of new issues continued to be narrow, and a conservative approach ruled the pricing of new shares, a situation which persists to this day. The stock market appeared set to follow a slow but steady growth in activity.

Then in 1993, the Bangladesh market was "discovered" by some foreign brokerage houses based out of the Far-East (Smith New Court Hong Kong being one). Against the backdrop of high market valuations globally, the shares of a few DSE companies (large local corporates like Beximco and Apex and some MNCs) were on offer at bargain prices. The foreign brokers managed to persuade some fund managers, who had a taste for exotic and risky Asian stock, to include some of these stocks in their portfolio. This was a turning point in our market.

Soon other foreign brokers and funds followed. In the scramble for shares, good judgment went out of the door. Foreign investors started picking up whatever was available. Local investors shook off their lethargy, and spurred by the avid appetite of foreign investors, started buying with new vigour. The spurt of activity drove valuations and PE ratios up and soon the market ran short of shares.

Taking advantage of the unmet demand for shares, new companies came to the market, many with little or no track record. Existing companies used the opportunity to make seasoned issues. The period from 1993 to 1995 saw a spurt of primary issues, a substantial chunk of which were placed with foreign investors, with the balance being offered to local investors though public offerings.

Today our stock market has more or less recovered from the protracted after-shocks of the 1996 turmoil. The regulators and market participants have quite rightly focussed their attention on removing supply and demand side constraints.

At the peak of this international interest in Bangladesh's stock market, an investors' conference was organised by Euromoney in January 1995. This was attended by several international fund managers, brokers, and investment banks. The government rolled out the red carpet and highlighted the various incentives that were available for inward portfolio investment.

However, local investors were somewhat aggrieved at being offered the remnants of new issues after foreign investors' appetite had been sated. The authorities agreed and imposed a one-year lock-in on foreign investment in primary shares. This move was not welcomed by the foreign investors who only a month ago were being wooed by the government at an international conference. Foreign interest in primary shares waned and the foreign investors seemed content to sit on their holdings for the time being. Fortunately, there was sufficient interest from local investors to keep the primary market ticking.

Around this time, the newly formed Securities and Exchange Commission was still getting its act together. The transition from a bureaucratic government department (CCI) to an independent watchdog body with a new mandate and powers is rarely a smooth one. For whatever reason, the relationship between DSE and its regulator SEC got off on the wrong foot. SEC enacted a new law regulating primary market activities through the formation of a new entity called a merchant bank. Interestingly, there was no significant role in the regulation for broker-dealers who had so far been carrying out investment banking activities.

In such a vibrant market, DSE was not in a mood to pay much heed to the new ideas coming out of SEC -- transparency of transactions, investor protection, responsibilities of a self regulatory organisation. Perhaps with the intention of bringing DSE into line, the government supported the formation of a new stock exchange in Chittagong. The idea was to introduce competition in the stock market and to allow local Chittagong companies to raise capital through a home-grown exchange.

The year 1996 will be remembered as a watershed in our stock market's history. The election of a new government after a year of political turmoil was apparently welcomed by the market, as evidenced by a healthy jump in the market index. But the index kept on rising - exponentially. So did trading activity. DSE's manual "open outcry" trading system failed to cope with this increased volume and trading activity spilled onto the streets. One side of Motijheel Road turned in to one long kerb market. New investors - professionals, government employees, housewives, students, small businessmen, traders - flocked to this market, attracted by the money-making machine called the Dhaka Stock Exchange.

FILE PHOTO: STAR

Dhaka Stock Exchange--the 1996 bubble

Amidst this mad rush of activity, the DSE seemed to lose focus on its regulatory responsibilities. The DSE council, entrusted with the responsibility of regulating the activities of broker-dealers, was composed of some of DSE's biggest brokers. There was a surge in proprietary trading. SEC appeared uncertain as to what action it should take to cool the market down. To quell price increases of 10 percent and above a day, SEC imposed circuit breakers. But this seemed to fuel the fire further. Public notices warning new investors of the dangers of buying shares in a bull run went unheeded. The DSE index rose from around 600 points in June to over 3,600 in October.

And then the inevitable collapse began. But it still took another two months for the market to return to the June level. It seemed that some people were still buying. New investors who had travelled all the way from distant town and cities after cashing out their land and other assets were not going to go away empty handed, no matter what others were saying about the market's collapse. Predictably, these newcomers took the biggest hit. The clever ones, including the proprietary traders, baled out long ago. Remember the foreign investors? Well they quietly offloaded their holdings and repatriated their winnings, all quite legally.

After the storm, one question was on everyone's lips "who engineered the bull run?" An embarrassed government hurriedly constituted an investigation into the alleged scam. The report, which was completed in a surprisingly short time, found circumstantial evidence of wrong-doings by some brokers and listed companies, against whom the government subsequently framed charges. A quick resolution of the share scam cases would have gone a long way towards restoring the credibility of the market, the players and the regulators. Sadly this was not to be. These cases are still pending today.

The consequences of the 1996 bubble were not all negative. For one, it focussed the minds of the regulators on the need for more relevant laws and effective implementation of the same. The SEC enacted a string of laws relating to primary issues, secondary market transactions, broker/dealer responsibilities, insider trading, and private mutual funds. To avoid the resurgence of kerb trading, all agreed that the trading capacity of the stock exchanges needed to be significantly increased. The two exchanges installed computerised trading systems and a central share depository was set up.

It has taken a while for the public's confidence on the stock market to return. Thanks to a spate of successful primary issues over the last couple years, the ghost of 1996 seems to be almost buried. However, most of these new issues were not voluntary. They were offered by banks and insurance companies in line with the terms of their operating licence agreements. There have been few issues made by good quality manufacturing or service companies.

A possible reason for this could be that issuers are not being able to sell shares at prices that they desire. New issue price premiums have to be justified with reference to net book value and endorsed by a rating agency. Whatever is the wisdom of such tinkering with valuation, the end result is that issue costs have gone up, and good companies seem unwilling to sell their shares cheaply. Furthermore, when new issues are grossly underpriced, the temptation to acquire large chunks of primary shares by dubious means would be great. The recent incident with the Premier Bank IPO is a case in point.

Today our stock market has more or less recovered from the protracted after-shocks of the 1996 turmoil. The regulators and market participants have quite rightly focussed their attention on removing supply and demand side constraints. However, one has to remember that a stock market is a free market, implying that it is not, and should not be, wholly controllable. The market's vibrancy and activity will in the end be determined by the underlying fundamentals in the economy.

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Asian bond market for development of regional stock exchanges

KITTIRATT NA-RANONG

THE ASEAN have launched the Asian Bond Markets Initiative (ABMI) since December 2002. Many efforts have been pursued under six working groups. Among these six working groups, the working group 1 is chaired by Thailand. There are a number of progresses. WG1 has continued to take a three-pronged approach toward its goal of creating new securitized debt instruments. At the same time, the efforts have also been put to increasing the supply of local currency bonds as well as the withholding tax issues.

In Thailand, the necessary amendments to the Royal Decree and Ministerial Regulations were made in order that the non-resident investors of Thai-baht Asian bonds will receive tax-free income from bond investment. The definition of the Asian bond for Thai environment has also been redefined to cover all types of government and quasi-government debt securities. Since the new definition of Thai-baht Asian bonds include both existing and newly-issued bonds, they account for large portion in Thai bond market. Thai-baht Asian bonds will be issued regularly and listed in the Bond Electronic Exchange (BEX) to ensure the transparency and promoting the liquidity.

The securitization in Thailand has been developed using the Thai Government Complex project to be the pilot. A number of concerns have been put into considerations, for example, tax issues, public debt burden, etc. However, the progresses in the securitization are observed.

A number of tasks has been done and will be done in the future to strengthen the Thai bond market. It is expected to have strong and liquid Thai bond market as one of the units of the Asian bond market. It is also believed that our Asian bond market, with Thai bond market, will ensure the stability of Asian economy in the near future.

The stock exchange of Thailand and Asian bond market initiative

To response to the ABMI tasks, the Stock Exchange of Thailand (SET) has set up the Bond Electronic Exchange (BEX) since November 2003 to perform the operations concerning fixed-income securities trading. Prior to the establishment of BEX, all bond trading transactions are done through the unorganized OTC. The retail investor has to rely on unobserved price-yield information if one wants to invest in bond. Liquidity of the bond trading through the unorganized is also one of the most crucial problems.

Since December 2004, the Ministry of Finance has set up the Thai Bond Market Steering Committee, chaired by the Minister of Finance, to look after the development of the Thai bond market according to the Thai Bond Market Development Master Plan: Stage II. The results from the first meeting of the steering committee, there are three main issues showing the remarkable moves of the Thai bond market. Firstly, it is agreed to promote the BEX to be the central electronic trading platform (Central ETP) for the Thai bond market. Secondly, the Thailand Securities Depository Co., Ltd, the subsidiary of the SET, was assigned as the depository center of all government and quasi-government bonds. Lastly, the Thai Bond Dealing Centre (ThaiBDC) was assigned to be the monitoring unit and information center for the Thai bond market.

BEX adopted the beta version electronic trading platform from the ThaiBDC. The FIRSTs (Fixed Income and Related Securities Trading system) emerges from the additional development to the adopted ETP. The FIRSTs is the electronic system for OTC bond market which complies to the regular practices of those institutional investors and dealers in the Thai bond market. The design of the FIRSTs intends to facilitate the Thai bond wholesale market. It is planned to launch by the last quarter of the 2005.

Besides to the FIRSTs, which is for the wholesale bond market, BEX also serves the retail bond investors through the automatic order matching (AOM) scheme. This AOM is the true exchange system with the pre-specified rules of matching, price-then-time. In the coming year of 2006, BEX plans to promote this AOM to the wide range of retail investors who are interested in bond investment.

Not only the developments of infrastructures, BEX also put extremely large efforts to educate both investors and professionals for the bond investment techniques. The Thailand Securities Institute (TSI), the business unit under SET, helps support the educational loads for BEX.

Conclusions

SET intends to help promote and support the ABMI in many ways. A number of tasks has been done and will be done in the future to strengthen the Thai bond market. It is expected to have strong and liquid Thai bond market as one of the units of the Asian bond market. It is also believed that our Asian bond market, with Thai bond market, will ensure the stability of Asian economy in the near future.

Kittiratt Na-Ranong is President, Stock Exchange of Thailand