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Fixing Bangladesh Capital Markets: *Now or Never*

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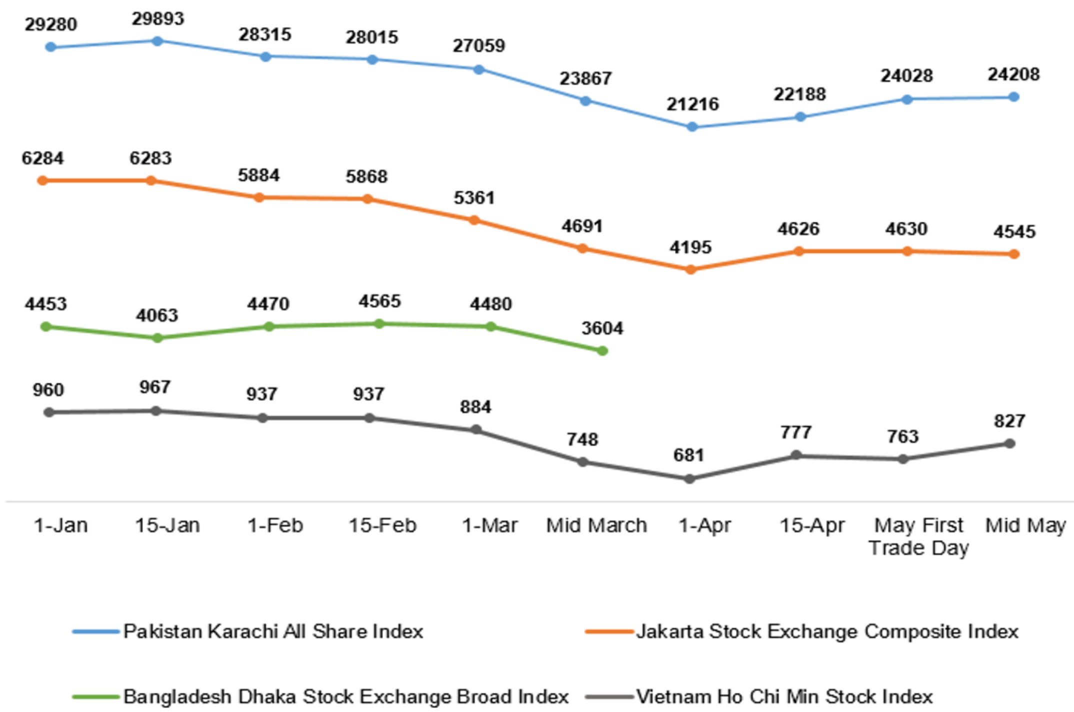
In an undergraduate course in the US, a Finance Professor had introduced the idea of capital markets to us, in the most remarkable way possible. The idea of capital markets, he told us, is to enable average citizens of a country to become co-owners of the country's best and brightest organizations. Picturesque? I thought so.

So, what of capital markets at home? If you have followed the markets in some fashion or the other in the recent past, you will have heard mostly negative news, especially if you missed the bull runs of the past. COVID-19 was also not kind to markets, the equal opportunity offender that it is. However, despite COVID's impact on the markets, despite the negative news, despite all despites, we wanted to take this opportunity, as the economy re-opens, and a new Chairperson joins BSEC, to revisit issues at hand that could fix systemic problems with the markets. The time is nigh.

First let's consider recent events. Our capital markets, the Dhaka Stock Exchange and the Chittagong Stock Exchange, were the only markets to be closed all the way through May. Even as COVID-19 pounded New York, two employees of the New York Stock Exchange tested positive, trading floors closed, their electronic trading continued with gusto. Meanwhile, peer capital markets never closed, and, in fact, have rebounded by now (Graph 1).

Graph 1: Market Trends: Dhaka, Jakarta, Vietnam, and Karachi



Should the Markets have Closed?

But why shouldn't the markets have closed, you may ask? Wasn't the entire economy under shut down?

An important reason why anyone invests in capital markets instead of other asset classes, is the ability to liquidate investments any time he or she needs the cash. Liquidity, i.e., the ability to sell, is inherent to the idea of capital markets. It is no different from you or I needing to access an ATM booth because we need to have cash at hand. This ability is even more important in times of crisis.

Once COVID broke out, many small retail investors were looking to sell shares because they needed access to emergency funds! Interfering with the essential nature of capital markets has never served us well. So, what should have been done, you ask? Let all offices and functions run as usual, and endanger lives of people?

Certainly not. Take the example of how banks functioned. Banks functioned by keeping select branches open, and rotating staff in these branches. Similarly, our stock brokerages could have remained open, if not the branches, perhaps only the head offices with minimal workforce on roster duty. Furthermore, to mitigate COVID risks, investors could trade either through mobile apps or placed orders via email or phone, without needing to set foot inside a brokerage office. A more pressing point is that the BSEC, CDBL, and Stock Exchanges need to allow intermediaries to go paperless! While the market was closed, international investors have expressed their frustration in public forums, since they depend on the reliability and rationality of policies. Risk specialists have chimed in and even suggested that DSE be rendered “non-investable” for foreign investors. Foreign investors are a critical component of our investment landscape. Below are three reasons why.

Three Reasons Why Foreign Investors Matter

First, the cumulative foreign investment, or foreign portfolio investment (FPI), can be quite large. Consider the fact that foreign investors have about $2.2 billion invested in Bangladesh ($3.0 billion at its peak). For the sake of comparison, as of 2019, our leather exports accounted for $1.2 billion; frozen fish (including shrimp) exports at $0.5 million, and pharmaceutical exports, $0.13 billion. Although FPI and exports are not an apples-to-apples comparison, it is worth underscoring the potential for scale of the former.

Second, because foreign investors invest for the long-term, they add much needed stability to markets. This stability is essential if we are to encourage our best and brightest companies to go public, and in a virtuous cycle, motivate other sophisticated investors to invest, whether institutional or retail.

Third, foreign investors constitute an incredible base of buyers for future capital raising initiatives of not just private companies, but the government as well, in case, we ever get to actualize sovereign bonds! How fantastic would sovereign bonds be, for long-term financing needs, such as infrastructure! Sovereign bonds would also provide a much-needed reprieve for the country’s banks, which are, unfortunately, the only source of long-term capital for companies. This is a systemic problem, and an egregious one, and if we are to care about growth, reliance on banks for investment growth has severe limitations.

At any rate, to go back to the original thrust of this piece: the markets will have opened by the time this goes to press. Another burning issue remains: the issue of the floor price!

The Issue of the Floor Price

On March 19, our market regulators came up with the nifty idea to fix a floor price, intended to prevent these pesky stocks from becoming cheaper and cheaper. Consequently, while global markets were falling, DSE registered an 11.2% jump, despite virtually non-existent trade volume.

Well-intentioned no doubt, floor prices are the enemy of trading, and by extension, liquidity, because, as long as prices artificially rest on the said floor, buyers and sellers cannot agree on an equilibrium price. Our floor price has also been widely condemned by both foreign and sophisticated local investors. Strategically, these are the investors we need to encourage if we want to improve the efficiency of our markets, and not the gamblers and the speculators.

Speculators and gamblers exist in every market, but the goal of a market regulator ought to be to increase the ratio of sophisticated retail and institutional investors to "balance" the speculators and the gamblers. The stock market is not inherently a casino, but behaves like a casino, when gamblers and speculators run amuck!
Junk and overvalued stocks stand to benefit from the floor price ruling. Losers are stocks with better fundamentals; institutional investors awaiting price discovery; retail investors holding margin loans; brokers, who lose out on commissions; and exchanges, deprived of tax earnings.

The elephant in the room, as far as brokers of foreign investment is concerned, is the MSCI Frontier Market 100 Index. MSCI is the short form for "Morgan Stanley Capital International." This is the gold standard of indexes for investors willing to put money in frontier or high-risk markets such as Bangladesh's.

The said index represents the performance of 100 leading and most liquid companies in 28 countries, e.g., Bahrain, Bangladesh, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Morocco, Nigeria, Oman, Romania, Serbia, Slovenia, Sri Lanka, Tunisia and Vietnam.

Persisting with the floor price means that stocks cannot become cheaper, although sometimes, they should, since stocks represent overall economic confidence. The economic confidence, or the lack thereof, in this case, is due to COVID-19 and no other reason. By sticking with the floor price, price discovery cannot happen, and sophisticated investors cannot trade at prices that reflect reality. This could lead to the worrisome outcome that capital markets could be downgraded from the MSCI Index. A downgrading would lead to an exodus of foreign investor funds, put us on the map of non-investable countries, and damage the development of the markets for years to come. Sticking with the floor price may comfort stakeholders in the near term, but damages can be significant.

If you want to learn from history, Pakistan attempted a similar asymmetric floor price policy in August 2008, during the global financial crisis. Karachi Stock Exchange regulators tried to force a floor price, to stop stock prices for falling continuously. This not only froze trading, but even after the floor price was removed, local and foreign investor confidence had been thoroughly eroded.

Now that the floor price has been set, what is the way out?

If the regulator is more comfortable with a gradual approach, there are ways of easing the floor price and exit strategies that are pragmatic. For one, the regulator can use a moving average of share prices, instead of the fixed average currently in play. Second, instead of stock specific floor prices in effect, the regulator could deploy a trading halt for 20-30 minutes, based on a daily percentage change limit. Not ideal, but less intrusive than the current floor price which was fixed for each stock by averaging close prices in a certain week. Meanwhile, floor price rule for block market transactions can be waived as block trades are privately negotiated, thus allowing investors to trade at previous limits if they wish to. This will not impact close price of the stock.

This is the right time not only to think through these current immediate changes required but also more structural changes, since COVID is forcing all sectors to do a hard reset and think long-term, with a view towards sustainability. The time is also right given a new Chairperson is at the helm of BSEC, a development that has been received positively by private sector stakeholders.

Of course, there are many possible changes, but below are some quick suggestions for the Chairperson to consider.

1. Expanding electronic trading. Although DSE uses Flextrade, a real-time trading platform that allows remote trading from any suitable device, only 5% of trades are executed online. For comparison, 95% of trades happen online in Chinese exchanges. Online trading helps maintain social and physical distancing in brokerage firms, and there is an urgent need to incentivize brokers and their customers to undergo the transition to digital.

2. Revisiting capital gains tax. Given that we need an image makeover in the community of foreign investors and capital gains tax is a long-standing impediment to overseas fund flow, this is a time to consider "tax loss harvesting." India and Pakistan both allow this facility. It basically enables taxing at an aggregate level, instead of taxing investors on each trade.

This is also the time to implement structural changes that can build a strong foundation for the markets. These are less COVID-related but more critical now than ever before.

3. Enhancing financial disclosure. BSEC should initiate the preparation of a uniform database such as the SEC filing system in the US. This entails hosting of a common server to which companies submit financial statements, which allows investors to easily access quarterly and annual reports, and drives a culture of transparency, and in turn, informed investing. This is no longer a good-to-have, but a must-have.

4. Corporate access. In the same vein, since value discovery is inherent to sophisticated investing, BSEC should make mandatory, online quarterly earnings disclosure programs where the leadership of listed companies host presentations on their performance. Fund managers, investors and analysts tune in, observe, and ask questions. This is an international best practice and already followed by Grameenphone, BRAC Bank, IDLC and Prime Bank at home. This dramatically improves confidence in the markets. If this is resisted by local companies that are listed, maybe blue chip firms ought to be encouraged to start this practice, in return for listing on our blue chip index, the DSE30. This also has the effect of elevating the profile of the DSE30 index, and in turn, of our overall markets.

There are also other changes required to encourage more IPOs of high-performing companies, but the above will have an overall impact of strengthening and deepening our markets. Investor literacy programs are also important since it is not only foreign investors for whom our markets need an image makeover, but local investors as well.

The best sort of makeover happens when change takes place from within, and at a substantive level. We no longer have the option of cosmetic changes, if this market is to fulfill its potential. The Bangladesh economy certainly deserves it, as do the people.