*SPECIAL SUPPLEMENT*

AIMS of BANGLADESH

# Underwriting : For Whom The Bell Tolls ?

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## KALEIDOSCOPE

The Securities and Exchange Commission (Merchant Banker & Portfolio Manager) Regulations 1996 designates the function of Issue Management, Underwriting of Public Issues and the Portfolio Management services exclusively for three types of merchant bankers only so licensed by the Commission.

The Merchant Banks intending to underwrite must have a capital of Tk 10 million and can not underwrite more than five times of the capital at one time. In cases where a Merchant Banker is also engaged in portfolio management, the combined underwriting exposure together with the amount of portfolio under management shall not exceed the five times limit, while such Merchant Banks are required to have a capital of Tk 20 million. Merchant Bankers who are only Issue Managers are to have a capital base of Tk 2.5 million only.

Before the regime of licensed Merchant Banks was introduced, traditionally the members of the Stock Exchanges, the Commercial Banks, the Insurance Companies and Mutual Funds used to underwrite public issues. Therefore, the Merchant Banker Regulations created a new breed of underwriters while entirely blocking out the traditional underwriters from the market.

## THE PITFALL

Questions could be raised if the Regulation is serving the need of the time. There is tremendous demand for IPOs, reflected in the huge over-subscription in most of the recent public issues. Therefore, expediting and facilitating IPOs should be a major concern now for the healthy growth of the market. However, the merchant banks currently licensed are very small in capital. Out of the twenty-six merchant banks, twenty with a total capital of only Tk 390 million have underwriting license. Assuming maximum five times exposure and no portfolio management function, a maximum utopian theoretical total of Tk 1950 million underwriting commitment is available at one point of time. This is not even adequate to accommodate four/five large issues at a time. The Regulations has thus, by default, squeezed the primary market to one or two small or medium sized issues at a time. Was it really the intent of the framers that the market participants should not have the capacity to service issues with a size like that of a KAFCO, AES, La Farge or the Jamuna Bridge, we may wonder.

In the most likely base-case scenario, the available underwriting commitment is even far less. Though the Regulations allow the merchant bankers to take underwriting exposure of five times of their capital, an accepted 'Prudent Man Rule' of the industry would not suggest exposure of more than fifty percent of capital at one point of time, nor would a rational thinking Board of Directors allow it. Therefore, the actual underwriting capacity of the market at one time is only about Tk 200 million. Records also corroborate that on an average five to seven underwriters usually underwrite an issue and assuming paid up capital of Tk 20 million each and no portfolio function, maximum underwriting commitment available per issue is only Tk 140 million, a not so encouraging indicator of the health and capacity of the market. May we or may we not like to amend the situation, could be a pertinent question in this regard from market observers.

## THE POINT OF CONTENTION

Though the Regulations allow the merchant banks to underwrite five times of their paid-up capital, which is a relatively higher limit given their low capital base, it does not allow any other market intermediary to underwrite public issues. The resultant effect is that it has left a demand-supply mismatch while also shrinking the market capacity. There is no denying of the fact that what the market needs, in order to stand on a strong foundation, is institutional participation. But debarring commercial banks, insurance companies and mutual fund from underwriting public issues acts as a disincentive. In fact, these institutions have been investing in IPOs through private placement and some are also active in the secondary market. If they are allowed to invest in the primary issues, it is not logical to bar them from underwriting the issues, as underwriting function is only a deemed investment, which is required to be funded only in cases of under-subscription. The role of banks, insurance companies and mutual funds in the development of the primary market is required to be properly evaluated in this regard.

## THE COMMERCIAL BANKS' FORAY IN MERCHANT BANKING

In the USA, the line of separation in business-jurisdiction among commercial banks, insurance companies, securities firms and merchant/investment banks was enforced through the Glass-Steagall Act 1933 that disciplined the US financial industry in the post depression era. The separation was drawn to reduce risks by restricting overexposure of the financial institutions.

Reference has been made to this particular US Act time and again in Bangladesh by the regulators while framing different securities market regulations ostensibly at the prescription of the donor agencies and as a justification for putting restrictions on the one hand and again to the fact of its repeal to justify relaxation of restrictions on the other, as it would serve the purpose of the day. Market participants tend to view both the stands as out of context and devoid of the needs and the ground realities prevailing in Bangladesh today.

The Financial Services Modernization Act 1999 (popularly known as the Gramm-Leach-Bliley Act) of the US essentially overturned the Glass-Steagall Act that divided the American financial system. The new Act intends to facilitate ‘affiliation’ among banks, securities firms and insurance companies and repeals restriction on banks ‘affiliating’ with securities firms as well as allows formation of a ‘financial holding company’ which can engage in a statutorily provided list of financial activities, including insurance and securities underwriting, merchant banking and portfolio investment through its different affiliates/subsidiaries. Activities that are ‘complementary’ to financial activities are also authorized. However, one interesting thing that is to be noted is that it does not allow banks to ‘directly’ engage in merchant banking activities as some quarters here has been arguing.

Senator Phil Gramm pointed out while moving the motion for annulment of the Glass-Steagall Act, "Over time the market and the regulators have used a variety of innovations to try to undo this separation. As a result, we have substantial competition occurring, but that is largely inefficient and costly, it is unstable, and it is not in the public interest for this situation to continue." This could be very much relevant in today’s US context but may not necessarily be true for a market like Bangladesh.

As our market is still at a pre-matured stage, the risk of overexposure and possibility of a collapse of confidence is very much on the higher side. We at AIMS therefore do not subscribe to the view of any unrestricted flouting of the borderline for now, especially where specialization and professional competence is essential, and by that we specifically point to the function of issue management and to some extent the portfolio management activities. There are also high possibilities of conflict of interest between these functions and that of commercial banking i.e. funding operations. However, the underwriting function is not necessarily a funding but a service oriented contingent risk taking activity, which logically fits in to the business of commercial banks as it does with insurance companies and of course to that of the mutual funds.

We share the strong view against commercial banks acting as issue managers for IPOs as it carries high risk of compromise in the quality of due-diligence. There could be a conflict of interest as delinquent borrowers of a commercial bank may be encouraged to raise public fund to pay off defaulted loans by resorting to temporary rescheduling as a window dressing.

As regards portfolio management activities, the commercial banks are already allowed by the Bangladesh Bank to extend credit facilities to their clients against purchase of shares, subject to the permissible limits and security measures. This activity could be designed and structured into various featured products by the banks and offered to their clients without any need of licensing from the SEC. However, would it be prudent for the banks to engage depositor’s fund in risky stock market investment would remain as a caveat here.

As for underwriting, since Banks have no restrictions or any limit, other than as permitted to the extent by their Board, on participating in primary issues through private placement, there is no valid logic why they should be barred from underwriting public issues, especially in which they are already participating through private placement. The same is also true for insurance companies, not to speak of mutual funds. The business of insurance companies is called ‘underwriting’ all over the world ! and even in our neighboring India, the largest underwriters are the mutual funds !!

## THE NEED OF THE HOUR

Our rules and regulations are required to be based on our needs and should be framed keeping in mind the prudential as well as the facilitatory roles in the development of the market.

As it has been evident from these presents, there is a dearth of underwriters of public issues under the current licensing system and also the maximum underwriting commitment that could be available at one time for a single issuer would not exceed Tk 200 million only, it is only imperative that the underwriting business for IPOs should be opened to commercial banks, insurance companies and mutual funds as well, apart from the licensed merchant bankers, for all practical purposes.

Since all these institutions are free to invest up to any limit in a public issue through pre-IPO private placement, there could not be any conceivable argument of conflict of interest if these institutions are allowed to underwrite such public issues. This is more so for the mutual funds, which are essentially independent trust funds that do not have any specific vested interest or agenda other than the development of the capital market.

What is required is just an insertion in the SEC Merchant Banker & Portfolio Manager Regulations 1996 to the effect that other than the scheduled commercial banks, insurance companies and registered mutual funds, all other entities engaging in the underwriting of public issues should procure license from the SEC. Could it be done ? We only can continue to hope so. Better late than never.