

Capital Markets Development and Securitization in Islamic Financial System*

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Significance of capital markets in any financial system can not be ignored. Development of capital markets require building of institutional infrastructure and framework to support smooth functioning of markets. Considering that Islamic banking is functioning on traditional instruments and needs for capital markets to provide access to funds and liquidity is felt badly, this paper discusses necessary steps involved in developing capital markets in a given financial system. The paper also identifies pitfalls which countries should avoid to achieve a vibrant and efficient capital market. This is followed by some suggestions for countries with interest - free banking system on how to develop capital markets.

Second part of the paper highlights the importance of liquidity enhancement in capital markets. Conventional capital markets have developed several sophisticated liquidity enhancement mechanisms including securitization. Paper argues that securitization is very critical for Islamic financial system since it enhances liquidity which provides opportunities for portfolio and risk management. With the introduction of portfolio and risk management tools, development of institutional investors will be encouraged which will lead to further development and sustainable growth of Islamic banking system.

* Extracted from Papers 1 & 2

Financial Engineering in Islamic Finance

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Islamic financial markets have earned due recognition from the international financial markets in the past decade by demonstrating the viability and practicality of banking compatible with the principle of Islamic financial system. Phenomenal success and growth is the result of increased demand for Islamic financial products reciprocated by financial intermediaries. Long-term presence of Muslim and non-Muslim financial institutions in the market is a vote of confidence and a sign of recognition. Islamic banking is not confined to the boundaries of Muslim countries anymore but is gaining roots in non-Muslim countries as well. Furthermore its clientele base is no more restricted to Muslims only.

Market is currently facing the major task of how to maintain upswing momentum and to achieve sustainable growth. Market size both in terms of assets base and annual turnover is still considered far below its true potential because the market is plagued by lack of depth and breadth, which are characteristics of a market with limited set of instruments. The process of innovation is complex and sensitive, as it requires multi-disciplinary considerations involving deep understanding of Islamic jurisprudence. All these factors make the process of innovation

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1. Introduction

The limitations of public finances as well as the systemic risk awareness of the banking systems in developing countries have led to growing interest in developing corporate bond markets. It is believed that well run and liquid corporate bond markets can play a critical role in supporting economic development in developing countries, both at the macroeconomic and microeconomic levels.

However, even under a properly designed policy framework in a developing country, only a very small number of selected corporate bond issuers ("major" corporate issuers) can be expected to enjoy a liquid secondary market of their bonds. The rest of corporate bond issuers ("minor" corporate issuers) will hardly have it. Despite their illiquid secondary market, minor corporate bond issuers can substantially benefit from the corporate bond market by opportunistically raising long-term funds on a deregulated primary market. An aggressive deregulation policy, in conjunction with market infrastructure building, is central to the development of an efficient primary market.

In other cases, macroeconomic constraints may not permit the existence or establishment of a large, liquid market for government bonds. But in such cases, a major corporate issuer may approximate the role of a sovereign, providing a *de facto* benchmark yield curve to a larger market in debt securities. These situations raise special policy issues that will also be discussed in this chapter.

This paper will start with an outline of both the macro- and microeconomic roles a corporate bond markets is expected to play in a developing economy, viewed in comparison with the markets for equities and bank loans. Section three offers a comparison of the characteristics of corporate bond markets in selected developed and developing countries, and will identify the policy implications suggested by these characteristics. Section four presents a conceptual framework delineating "major" and "minor" issuers, highlighting the limited liquidity which challenges most developing corporate bond markets. Section five outlines the centrality of the primary market in light of institutional investors' behavior, and explains why a focus on aggressive deregulation of the primary market is key to the development of a corporate bond market. Section six analyzes the key stages of development of corporate bond markets, including disclosure systems, credit rating systems, securities registration, and bankruptcy laws. The last two sections examine a macroeconomic policy dilemma which can ensnare some developing countries when they work for public finance consolidation, the role of corporate bonds as *de facto* benchmarks, and the institutional characteristics conducive to liquid secondary markets for corporate bonds.

2. Expected roles of corporate bond markets

The benefits of a government bond market are not limited to the financing of a country's fiscal deficit, or achieving certain objectives in the area of monetary policy, such as the sterilization of inward capital flows. For a developing country, a functioning government bond market helps facilitate the growth and functioning of a corporate bond market, in part by establishing a benchmark yield curve for pricing fixed-income instruments like bonds.

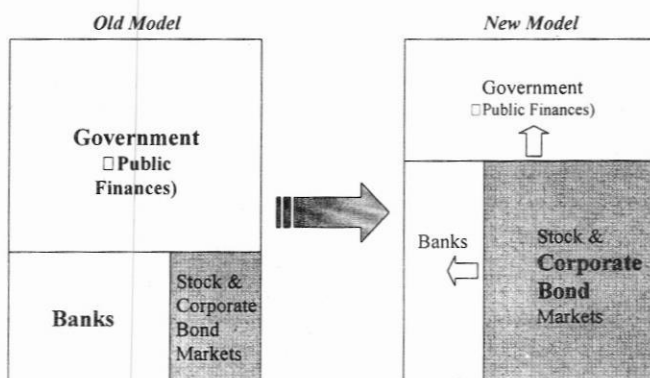
2.1. Macroeconomic roles

Why are corporate bond markets important for developing countries? While in any economy a satisfactory pace of economic growth cannot be achieved without adequate debt capital, most developing countries face an additional challenge in the form of banking systems unable to provide long-term debt in a sound or efficient manner.

A corporate bond market is generally expected to play the following roles:

- diffusing stresses on the banking sector by diversifying credit risks across the economy;
- supplying long-term funds for long-term investment needs;
- supplying long-term investment products for long-term investors;
- lowering funding costs by avoiding a liquidity premium;
- providing products with flexibility to meet the specific needs of investors and borrowers; and
- allocating capital more efficiently.

Figure 1: Increasing Roles of Corporate Bond Markets in Economic Development



Public finances and bank loans increasingly give way to capital markets.

Among these roles, the most commonly known is the provision of long-term funds for long-term investments. In today's world, private sector growth depends on capital-intensive production technologies, which in turn entail long-term investment risks (Demirgüç-Kunt, 1995). Long-term investment risks can be better managed when paired with long-term capital. A functioning corporate bond market can intermediate between long-term investment needs and long-term capital for private sector activities. These roles, commonly noted in developed economies, are becoming increasingly relevant objectives in developing countries.

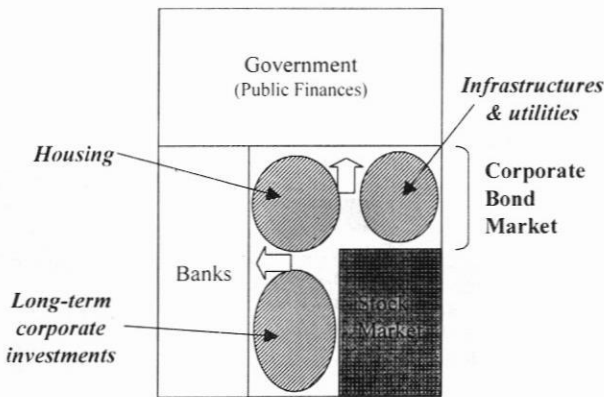
But why are domestic corporate bond markets rather than bank lending or public finances now considered so crucial to developing economies? Two major factors can be pointed out. They are (i) the reducing roles of bank loans and (ii) public finances in developing economies, and are schematically illustrated in Figure 1.

The Asian financial crisis which began in Summer 1997 dramatically underscored the limitations of even reasonably regulated, supervised, capitalized and managed banking systems in financing industrial investments. The primary role of a banking system is to create and maintain the liquidity needed to finance production, acting within a short-term horizon (Bossone, 1998). Banking systems cannot be the sole source of long-term investment capital without making an economy dangerously vulnerable to external shocks.

Second, many developing countries have embarked upon significant long-term structural adjustment programs which have both increased the size and capital requirements of the private sector and led to a consolidation of public finances in such areas as infrastructure development.

It is believed that corporate debt markets can address these new requirements, providing

Figure 2: Major Sub-markets of Corporate Bond Market



Infrastructures, utilities, housing and long-term corporate investments, among other things, are increasingly expected to be financed by corporate bond issuance.

capital to those areas ill served by the public purse or the banking sector, in addition to the equity capital supplied through the stock market and private equity investors. And as we can see in Figure 1, a functioning corporate bond market is usually divided into several key "sub-markets," including infrastructure and utilities, housing, and long-term corporate investments.

2.2. Microeconomic comparisons

2.2.1. Comparison with equity

An economy will generally grow faster given enterprises have access to financial leverage, because the growth pace and potential of private enterprises will be significantly increased if debt capital is efficiently available.

The attractiveness of debt capital is based on a number of factors, including the fear of ownership dilution through equity financing, and the high historical cost of equity capital relative to debt.

In many cases, controlling shareholders do not want to dilute their equity stakes by raising additional equity capital from outside for expansion. If banks' lending capacity is constrained, the existing shareholders may choose not to make additional investments for the corporation's future. And, as noted above, if banks recklessly accommodate corporations' long-term investments with their own short-term liabilities, that is, deposits, a country's banking system can become dangerously vulnerable to external shocks.

In general, equity capital is costlier than debt, because of two main factors. First, equity investment is by definition riskier than debt investment, and, therefore, the equity investor demands a higher return than a lender or debt investor. Second, interest expenses on debt are usually tax-deductible at a corporate level, whereas corporate profits are usually taxed before dividends on shares are retained or distributed to shareholders.

2.2.2. Comparison with bank loans

The two methods private enterprises most often use for raising debt – taking bank loans or issuing bonds – are commonly termed "indirect" and "direct" financing. Besides each avenue's unique macroeconomic role, their differences can be seen at a corporate level. Table 1 below compares the typical characteristics of publicly-offered bonds and bank loans in a well-developed capital market.

This quick comparison suggests that bonds are generally more attractive for long-term, large-scale and opportunistic borrowing, and bank loans for small, short-term, and ongoing financing. On a company's balance sheet, bonds are more suitable for the financing of fixed assets and investments, whereas bank loans are a superior way to finance inventories and other current asset accounts.

For a company to reap the intended benefits of cost effectiveness of bond financing, strong cash management skills at a corporate level are required. In general, the irregular pattern of cash flows arising from long-term projects inevitably does not match the regular pattern of issue proceeds, interest payments and principal redemption characteristic of bonds. The inability of a company to effectively manage such cash flow

Table 1: Publicly Offered Bonds vs Bank Loans

	Publicly Offered Bonds	Bank Loans
Size of financing	Substantially large. No particular limit. A smaller issue size is impractical.	Smaller unless syndicated. Limited by a credit line available to a borrower, industry, country and other category to which the borrower belongs
Term	Usually one year or longer	Usually shorter and rolled over. Limited by credit policy of a bank
Repayment	Bullet or limited prepayment patters. Generally inflexible.	Generally flexible.
Interest rate	Fixed or floating rates	Floating rates for long maturities
All-in cost	Normally cheaper, depending on market conditions. Very cheap for opportunistic deals.	Normally more expensive.
Swap	Available	Available
Structured financing	Widely available	Limited
Credit analysis	Standardized rating by rating agencies	Proprietary credit analysis by a bank
Security	Normally unsecured	Normally secured
Use of proceeds	Normally not restricted	Normally restricted
Listing	Either listed or non-listed	Non-listed
Creditors	"Unspecific, many" investors, including individuals, corporations, banks, insurance companies, pension funds, mutual funds, etc.	A small number of banks and some other financial institutions
Transferability & Liquidity	Readily transferable, and limited liquidity except for "major" issuers	Not transferable, and no liquidity

Note: Each individual bonds and loans may have characteristics different from the generalized descriptions above.

deviations through tactical investment or short-term borrowing can significantly defeat the purpose of long-term bond financing. Therefore, the development of corporate finance knowledge and skills on the part of issuing corporations is indispensable for the development of corporate bond markets.

3. Overview of corporate bond markets

3.1. Developed countries

Corporate bond markets in developed countries share some characteristics, which may contrast with common perceptions. The characteristics are summarized as follows:

1. The corporate bond market in the United States is by far the largest among developed countries, presumably due to the country's unique financial history;
2. Corporate bond markets in other developed countries, which have been growing quite dramatically, are in turn dominated by the bonds of financial institutions rather than non-financial companies;
3. The secondary market for corporate bonds, except for a limited number of "major issues", are generally illiquid. This makes the primary markets the center of activity;
4. Institutional investors, rather than individual investors, are the key players in corporate bond markets in developed countries, and they trade bonds on the counter rather than on the exchange; and,
5. The development of corporate bond markets in developed countries was preceded by that of government bond markets, which had been long preceded by years of capital accumulation through industrial development.

Among developed countries, the bond market of the United States has several distinct features.

Until as late as 1994, the commercial banks of U.S. were confined to their home states.³

Moreover, under so-called unit banking rules, nearly half the states required banks to do all their business from one location. This so limited the lending capacity of banks that they were largely unable to meet the funding needs of companies expanding nationally, let alone their need for long-term capital. As a result, the corporate bond market, in

Table 2: Selected Industrial Countries – Domestic Debt Securities by Nationality of Issuers (1997)

(In US\$ Billion)

	France	Germany	Italy	Japan	The Netherlands	UK	USA	Total
GDP	1,392.5	2,089.9	1,139.0	4,197.4	362.6	1,312.3	8,110.9	18,604.6
Total Debt Securities	1,113.2	1,730.0	1,471.7	4,433.7	227.8	767.8	12,414.6	22,158.8
<i>Against GDP</i>	79.9%	82.8%	129.2%	105.6%	62.8%	58.5%	153.1%	119.1%
Public Sector	647.4	777.5	1,123.4	3,116.8	177.5	465.4	7,337.1	13,645.1
<i>Against GDP</i>	46.5%	37.2%	98.6%	74.3%	49.0%	35.5%	90.5%	73.3%
<i>Against Total Debt Securities</i>	58.2%	44.9%	76.3%	70.3%	77.9%	60.6%	59.1%	61.6%
Private Sector	465.8	952.5	348.3	1,316.9	50.3	302.4	5,077.5	8,513.7
<i>Against GDP</i>	33.5%	45.6%	30.6%	31.4%	13.9%	23.0%	62.6%	45.8%
<i>Against Total Debt Securities</i>	41.8%	55.1%	23.7%	29.7%	22.1%	39.4%	40.9%	38.4%

Source? Table 1 in Schinasi and Smith (1998) and World Economic Outlook database

Table 3: Debt Securities Financing by Non-Financial Firms in Selected Industrial Countries

(As a percentage of total funds raised in financial markets)

	Germany	Italy	Japan	The Netherlands	USA
1990	0.0%	0.2%	14.2%	3.4%	48.6%
1991	0.0%	1.0%	10.4%	-2.5%	33.5%
1992	0.1%	0.2%	4.6%	-0.1%	18.2%
1993	0.0%	-6.5%	7.1%	12.0%	10.6%
1994	0.0%	-2.9%	11.5%	-	27.7%

Source: Table 3 in Schinasi and Smith (1998). Original sources? OECD, *Financial Statistics: Non-Financial Enterprises Financial Statements (Part III)*; R. Todd Smith, "Markets or Corporate Debt Securities", IMF, Working Paper No 95/67; Deutsche Bank, *KapitalMarket Statistik*. Notes: For Germany, does not include international issues of bonds. For Italy and the Netherlands, does not include commercial paper.

conjunction with the stock market, developed as a mechanism through which companies could raise capital from across the country – as well as from abroad.

The markets for debt securities in Western European countries and Japan are much smaller than that of the U.S., not only in absolute terms but also as of percentage of GDP (see Table 2). As Table 3 illustrates, the issues of financial institutions also dominate them. According to Table 2, corporate bonds in Germany accounted for 55.1% of the total volume of debt securities outstanding in 1997, as compared to 40.9% in the U.S. However, as underscored in Table 4, most German corporate bonds were those issued by financial institutions, namely, banks. Non-financial corporate bonds were marginal. The percentage of non-financial corporate debt issues in Japan, second only to the U.S. and steadily rising, remained at about half of that in the U.S.

Once they are purchased and settle into institutional investors' portfolios upon issuance or shortly thereafter, the majority of corporate bonds do not change hands until they come to maturity. Even in the U.S., more than 95% of corporate bond issues outstanding have not traded at all in the secondary market. Nonetheless, corporations raised \$663.1 billion and \$861.3 billion in 1997 and 1998 respectively in the U.S. corporate bond market⁴.

Table 4: Debt Securities of Non-Financial Corporate Sector Relative to Financial Sector

	Germany	Japan	USA
1992	0.3%	34.7%	119.0%
1993	0.2%	33.9%	107.0%
1994	0.2%	37.1%	97.7%
1995	0.2%	40.1%	89.4%
1996	0.2%	41.3%	81.5%

From Table 5 in Schinasi and Smith (1998). Originally from Federal Reserve Bulletin; Deutsche Bundesbank Monthly Report; Bank of Japan, Economic Statistics. Note that non-financial sector debt securities include bonds and commercial paper outstanding, and financial sector debt securities include bonds and short-term paper.

⁴ BIS, *International Banking and Financial Market Development* (Quarterly publication), November 1999

Corporate bonds issued in developed countries are mainly bought by institutional investors. The holdings of corporate bonds by households in the United States and Japan both accounted for 12.2% of the total amounts outstanding at the end of 1998; and those by non-financial corporations in the United States and Japan accounted for only 1.5% and 6.9%, respectively⁵. The dominance of institutional investors is due to the fact that long-term debt funds idling in households and corporations can generally achieve superior risk/return tradeoffs through institutional investors who specialize in collecting and managing funds of specific characteristics.

3.2. Developing countries

3.2.1. The economic context

The development of corporate bond markets in the U.S. and other developed countries was preceded by that of stock and government bond markets, which in turn had been preceded by years of capital accumulation through industrial development. If developing countries were to repeat this historical process, current efforts to help them foster corporate bond markets would be irrelevant, unless they have already achieved a relatively high level of economic development. In fact, they have not.

It is therefore crucial to acknowledge that current efforts to introduce corporate bond markets into developing countries' economies are doing so at an earlier stage of capital accumulation in their economies. At the same time, these developing economies are generally smaller in size. This suggests a possibly different process of development for the market framework and infrastructure for corporate bond markets, and a possibly different sequencing of institutional development, depending on particular economic situations of a country.

3.2.2. Comparisons with developed countries

Most developing country corporate bond markets are small even relative to their own GDPs. Table 5 underscores just how marginal these local corporate bond markets are in comparison with other financial markets, while Figure 3-B illustrates developing countries' extraordinary dependence on bank loans. Out of the ten developing countries from which IFC has been able to collect reliable statistics on debt markets, only the corporate bond markets of Malaysia and Korea exceed 10% of GDP. Despite their relative diversity⁶, a majority of Korean corporate bond issues had guarantees from

⁵ FRB, *Flow of Funds Accounts of the United States 1998* (released on March 12, 1999), and Bank of Japan, *Shikin Junkan Kanjo 1998* (Flow of Funds Accounts 1998). The corporate bonds in Japan are "industrial securities" (straight bonds, convertible bonds, and bonds with equity warrants) and bank debentures.

⁶ The distribution by sector of corporate bonds issued from February 1997 to October 1999 in Korea is as follows: electric & electronic equipment: 33%; transportation equipment: 21%; whole sale trade: 15%; petroleum and chemical 8%; metal: 6%; communications: 5%; machinery: 4%; construction: 3%; and miscellaneous: 5%. (IFCs bond database)

Table 5: GDPs, Equities, Government Bonds, Corporate Bonds in Selected Developing and Developed Countries

Country	GDP		Total Equities		Bank Claims on Private Sector	Total Bonds		Government Bonds	Corporate Bonds		
	\$	Log10	\$	%	\$	\$	%	\$	%		
Czech Republic	\$56.0	1.75	\$12.05	21.5%	\$35.20	\$6.62	11.8%	\$2.33	4.2%	\$3.72	6.6%
Hungary	\$48.0	1.68	\$14.03	29.2%	\$8.26	\$12.04	25.1%	\$11.80	24.6%	\$0.24	0.5%
India	\$372.0	2.57	\$105.19	28.3%	\$98.79	\$108.88	29.3%	\$63.07	17.0%	\$16.49	4.4%
Indonesia	\$92.0	1.96	\$22.10	24.0%	\$63.37	\$1.70	1.8%	\$0.00	0.0%	\$1.00	1.1%
Korea	\$321.0	2.51	\$114.59	35.7%	\$264.67	\$277.78	86.5%	\$178.46	55.6%	\$99.32	30.9%
Malaysia	\$72.0	1.86	\$98.56	136.9%	\$74.92	\$37.78	52.5%	\$19.74	27.4%	\$15.13	21.0%
Philippines	\$65.0	1.81	\$35.31	54.3%	\$32.71	\$9.26	14.2%	\$7.87	12.1%	\$1.26	1.9%
Poland	\$158.0	2.20	\$20.46	13.0%	\$30.84	\$12.63	8.0%	\$12.63	8.0%	\$0.00	0.0%
Slovak Republic	\$20.0	1.30	\$0.97	4.8%	\$8.92	\$3.39	16.9%	\$2.78	13.9%	\$0.51	2.6%
Thailand	\$113.0	2.05	\$34.90	30.9%	\$144.44	\$21.02	18.6%	\$9.67	8.6%	\$3.46	3.1%
France	\$1,455.0	3.16	\$991.48	68.1%	\$1,121.82	\$1,209.90	83.2%	\$731.30	50.3%	\$478.60	32.9%
Germany	\$2,123.0	3.33	\$1,093.96	51.5%	\$2,672.98	\$2,005.90	94.5%	\$865.90	40.8%	\$1,140.00	53.7%
Italy	\$1,186.0	3.07	\$569.73	48.0%	\$740.64	\$1,579.90	133.2%	\$1,215.60	102.5%	\$364.30	30.7%
Japan	\$3,787.0	3.58	\$2,495.76	65.9%	\$5,046.28	\$5,213.60	137.7%	\$3,700.50	97.7%	\$1,513.10	40.0%
The Netherlands	\$378.0	2.58	\$603.18	159.6%	\$468.73	\$243.60	64.4%	\$199.40	52.8%	\$44.20	11.7%
U.K.	\$1,399.0	3.15	\$2,374.27	169.7%	\$1,690.47	\$852.80	61.0%	\$464.30	33.2%	\$388.50	27.8%
USA	\$8,511.0	3.93	\$13,451.35	158.0%	\$5,412.90	\$13,973.20	164.2%	\$8,002.40	94.0%	\$5,970.80	70.2%

Sources: JPMorgan, *World Financial Markets*; Institute of International Finance (IIF), IFC, *Emerging Stock Markets Factbook 1999*, IMF, *International Financial Statistics*, IFC, Emerging Markets Information Center Bond Database; BIS, *International Banking and International Market Developments*.

Notes:

- GDP figures are Nominal GDP for 1998 from JPMorgan's *World Financial Markets* (except Slovakia).
- GDP figure for the Slovak Republic is Nominal GDP for 1998 from the Institute of International Finance (IIF).
- Equities figures are for December 1998 and are from IFC's *Emerging Stock Markets Factbook 1999*.
- Bank claims on the private sector are from the IMF's *International Financial Statistics* and are for end-1998 (except France and the Netherlands, end-first quarter 1999, and Hungary, end-third quarter 1996). The amounts shown are US\$ equivalents for local currency denominated bank claims. Bank claims are the closest available proxy for bank loans, although claims could also other claims, such as, equity securities. Claims on the private sector, therefore, should approximate to loans to the private sector.
- Bond figures for the ten developing countries include only debt securities with initial maturities of at least one year and are from IFC's Emerging Markets Information Center Bond Database. All data as of December 1998, except India (March 1998) and the Philippines (December 1997). Figures for the Slovak Republic are estimates. The amounts shown are US\$ equivalents for local currency denominated bonds.
- Bond figures for the seven developed countries are debt securities of all maturities, not just bonds, and are for December 1998.

commercial banks⁷, and, therefore can be regarded as a type of bank loans. Another example of a commercial banking industry's dominance of a corporate bond market is offered by the Czech Republic, where bonds issued by that country's troubled banks accounted for 77% of all corporate bonds issued from February 1997 to October 1999⁸.

Despite the limitations of available data⁹, this picture gets clearer still when the corporate

⁷ In 1996 and 1997, 93% and 87% of corporate bonds were guaranteed, with the remaining 7% and 13% non-guaranteed, respectively. In 1998 these proportions had altered drastically with 33% guaranteed and 67% non-guaranteed. (The Bank of Korea and, Korea Securities Dealers Association, KSDA).

⁸ The distribution by sector of corporate bonds issued from February 1997 to October 1999 in Czech Republic is as follows: banking: 77%; electric, gas and sanitary: 9%; metal: 7%; communications: 3%; oil, gas, petroleum: 2%; and miscellaneous: 5%. (IFC's Bond database)

⁹ Though corporate bond markets already exist in one way or another in many developing countries, it is highly problematic to gather reliable statistical data on their corporate bond markets. More surprisingly, reasonable data of the corporate bond markets in developed countries consistent across countries is not available. For example, bond data for the developed countries was taken from *BIS Quarterly Review*, where as that for the developing countries were taken from IFC's bond database, but not from the BIS source. This is because BIS data does not have amounts of domestic debt securities in some of the developing

bond markets of developing countries are compared directly with those in developed countries. Table 5, which was compiled from various sources, shows the 1998 nominal GDPs, their common logarithms, the U.S. dollar amounts and percentages of GDPs for equities and bonds outstanding in selected developing and developed countries¹⁰.

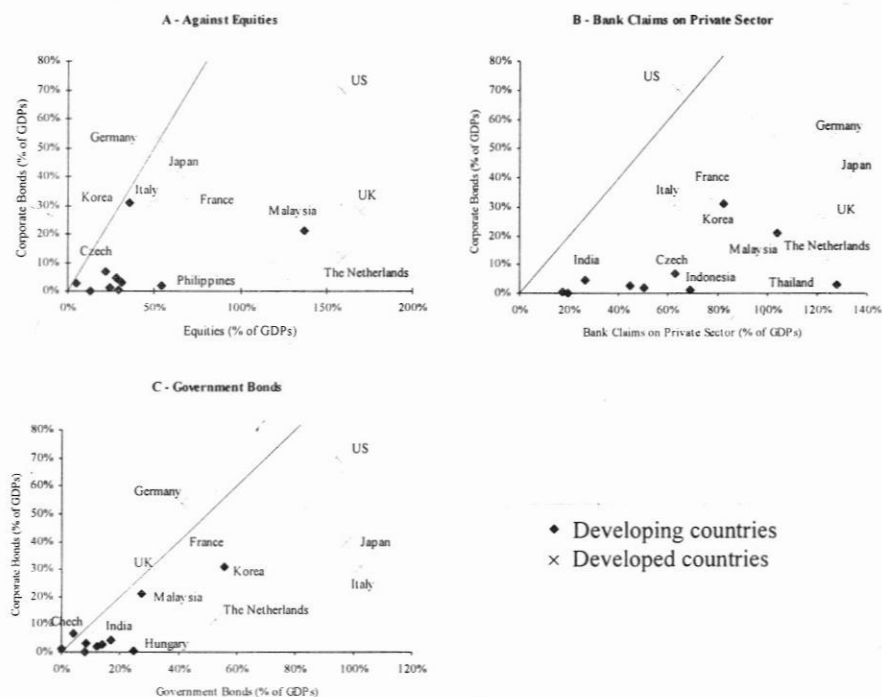
countries such as Indonesia, Philippines, Slovakia and Thailand, and has amounts different from the IFC data for the other developing countries. Therefore, there are some differences in definitions of corporate bonds or debt securities issued by corporate issuers.

¹⁰ Korea is no longer usually considered to be a developing country. However, since the Asian Financial Crisis in 1997, Korea has again become a World Bank Group client country eligible for World Bank and IFC programs. As such, it is included in IFC's bond database and is here categorized as a developing country.

Table 6: Correlation Coefficients between Market Sizes – Corporate Bonds vs Equities, Bank Loans, or Gov't Bonds

% of GNPs for	Corporate Bonds as % of GDPs of Countries		
	All	Developed	Developing
Equities	0.5038	-0.1099	0.5108
Bank Claims on P/S	0.4235	-0.3195	0.4694
Gov't Bonds	0.7749	0.3163	0.8477

Figure 3: Market Sizes – Corporate Bonds vs Equities, Bank Loans, or Gov't Bonds



Drawing from these data, table 6 shows the correlation coefficients between, on the one hand, the relative sizes of corporate bonds and, on the other, equities, bank claims on the private sector (as a proxy for bank loans to corporations) and government bonds. The coefficients were calculated separately for the developed countries, the developing countries and all countries. Figure 3 offers scatter diagrams of the same variables.

There are some direct relationships between the relative size of the corporate bond market in a given country and the relative size of its equity, bank loan, or government

Table 7: Correlation Coefficients between Market Sizes – Equities, Bank Loans, Total Bonds, Gov't Bonds, or Corporate Bonds vs Common Logarithm of GDPs

% of GNPs for	Common Logarithm of GDPs of		
	Countries		
	All	Developed	Developing
Equities	0.4998	-0.0770	0.0107
Bank Claims on P/S	0.4184	-0.2678	0.0544
Total Bonds	0.8713	0.7788	0.4373
Gov't Bonds	0.7899	0.4622	0.3690
Corporate Bonds	0.8685	0.9161	0.3797

bond market¹¹. The latter three markets are generally instituted ahead of a corporate bond market. Furthermore, the direct correlation coefficients are considerably higher in the developing countries (0.5108 against -0.1099, and 0.8477 against 0.3163). These may imply that a country's financial system, including equity, bank loan and government bond markets, needs to achieve a certain level of development prior to the development of a corporate bond market, especially in an earlier stage of economic development. The leading role of the government bond market is more obvious.

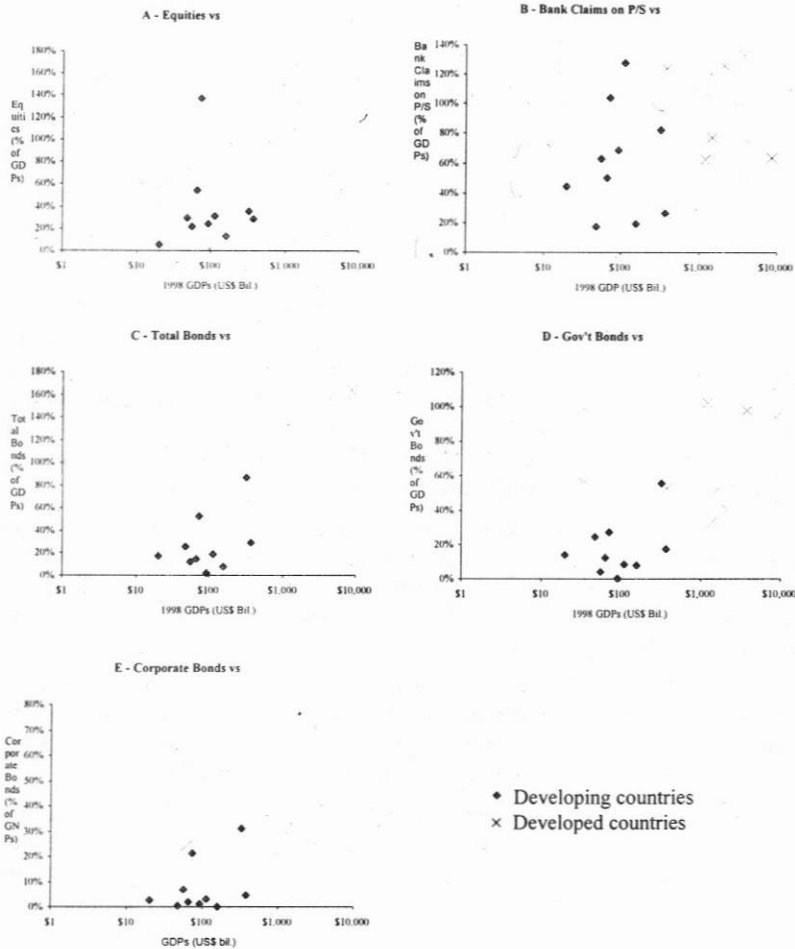
The relationship between the bank loan and corporate bond markets in developed countries is invert (-0.3195), while that in developing countries is direct (0.4694). This suggests that corporate bonds can be substituted for bank loans on the longer end of the yield curve, and the potential ability of a corporate bond market to relieve the sometimes unbearable burdens placed on banking systems in developing countries.

Using the same data, Table 7 shows correlation coefficients between, on the one hand, the common logarithms of the 1998 nominal GDPs and, on the other, equities, bank claims on private sector, total bonds (government plus corporate bonds), government bonds and corporate bonds. Figure 4 offers scatter diagrams of the same variables.

The table and figure reveal very interesting relationships between the absolute size of a country's GDP and different financial sub-markets. First, the logarithmic size of the GDP has little relationship with the relative sizes of equity or bank loan markets, excepting the inverse relationship between bank loan markets in developed countries. This also supports the notion that a corporate bond market can act as a partial substitute for a bank loan market. Second, the size of a country's corporate bond market relative to its GDP is directly correlated with the logarithmic size of its GDP and may be more so as the economy gets larger. This may imply that economic development will be accompanied by an increasingly important role for a corporate bond market, and that a larger population tends to increase the relative size of a corporate bond market. In other words, a country

¹¹ As will be discussed later, it is appropriate in this context to broaden the concept of a government bond market to include a market of major corporate bond issues whose secondary market is liquid enough to substitute the function of a government bond market.

Figure 4: Market Sizes – Equities, Bank Loans, Total Bonds, Gov't Bonds, or Corporate Bonds vs Common Logarithm of GDPs



with a small population may not have the potential for a sizable corporate bond market unless its per capita income increases dramatically.

Summing up the analyses above, Table 8 outlines the policy implications of each possible interpretation of the data for the development of corporate bond markets in developing countries.

Table 8: Policy Implications for Corporate Bond Market Development

Possible interpretations of the data	Policy implications
A country's financial system in general and the government bond market in particular need to be at a certain level of maturity prior to the development of a corporate bond market, especially at an earlier stage of economic development.	Corporate bond market development should be preemptively geared into the whole financial market development. It should timely follow the developments of commercial banking and a government bond market.
The corporate bond market in a country can substitute part of the bank loan market, and is potentially able to relieve the stressed banking system in a developing country of unbearable burden.	Corporate bond market development should be designed into restructuring of the banking system. An incentive mechanism should be devised to alleviate resistance from the commercial banking sector against a rapid development of a corporate bond market.
Economic development will be accompanied by an increasing role of a corporate bond market.	Unlike the developed countries that completed their capital accumulation process in a pre-open economy era, the underdevelopment of the corporate bond market in a developing country may risk the country's economic development itself in the environments of an open economy. Policymakers need to accelerate a shift from a merit system to a disclosure system, i.e., to accelerate financial deregulation. Let the private sector play a greater role.
A larger population of a country will likely make the relative size of a corporate bond market larger. (A country with a small population may not have potential for a sizable corporate bond market unless its per capita income increases drastically.)	Economic unification may enhance the potential for corporate bond market development. Though it is a politically challenging task, an example is UEMOA (Union économique et monétaire ouest-africaine) in the West Africa.

4. "Major" and "Minor" Corporate Issuers¹²

It is essential to distinguish between "major" and "minor" issuers of corporate bonds, especially in the context of developing countries. The distinction presumably makes it easier for policymakers in developing countries to realistically lay out a strategy for the debt market as a whole. The two categories of issuers and their bonds differ from each other substantially. Major corporate issuers may enjoy a secondary market for their bonds liquid enough for the bonds' secondary market prices to form a benchmark yield curve. In contrast, bonds issued by minor issuers will likely be illiquid. But this does not lessen the importance of the primary market even for minor issuers as a long-term funding source, meaning both major and minor issuers can benefit from the development of a functioning corporate bond market.

4.1. Major corporate bond issuers

By "major" issuers we mean those which provide investors with a regular, sizable and stable supply of high quality and uniform bonds through public offerings. They may be termed "impatient traders" with a high demand for immediacy. They issue their bonds almost on a regular basis, say, every week, month, or quarter, so that the investors can reasonably anticipate when the bonds will be available for sale. Their issue timing is basically cyclical and somewhat indifferent to ever-changing market conditions to meet their continuous funding needs. They are not opportunistic. Under normal circumstances, their issue size is large enough to meet a substantial part of investment demand across the market, and their issues are relatively consistent in size. They are financially strong and competently manage their business operations, meaning investors have a great deal of trust in their ability to pay the interests and principal on their bonds in a timely manner. Such strength and trustworthiness allows them a "Triple-A" or otherwise high grade from one or more private rating agencies. Their issues include many of identical or similar maturity or structure, for instance, unsecured, fixed-rate, straight 3-, 5- or 10-year bonds. Ideally, some of them should be made fungible¹³ by reopening outstanding issues at consecutive auctions.

As a result, major corporate bonds will be widely held in the market, and they are likely to be actively traded on the secondary market.

Suitable candidates for major corporate issuers are infrastructure and utility companies, housing finance companies, and development finance companies – strategic enterprises necessary for social and industrial development in developing countries.

¹² The terminology of "major" and "minor" issuers or "major" and "minor" bonds is not common in the securities industry. It is arbitrarily coined here to present a conceptual framework for devising a strategy for debt market development in a developing country.

¹³ Interchangeable. Fungible bonds are bonds issued by the same issuer in several tranches with the same nominal coupon rate as well as identical dates for the payment of coupons and for repayment of the principal at maturity; therefore, they can be substituted for purposes of trading, clearing, settlement, coupon payments, repayment, etc. The fungibility of bond ensures the depth and continuous liquidity of the market.

Such enterprises tend to have a regular, sizable and stable demand for long-term funds. Properly structured and operated, they can therefore provide investors with a regular, sizable and stable supply of uniform and high-quality bonds through public offerings. Their suitability as major issuers will be further analyzed later in Section 8.1.

4.2. Minor corporate bond issuers

Most corporate bond issuers or their issues cannot meet the stringent criteria for “major” corporate bond issuers or issues. Hence, they are “minor”. The term “minor” no way means that such issuers are marginal in their country’s economic development. Simply their financing patterns in the debt market do not qualify for “major” corporate issuers or issues. Typically, their individual issues are too small in size for exactly identical debt securities to be extensively distributed among a wide range of investors across the economy and frequently change hands.

While they may be of high quality in terms of creditworthiness, “minor” issuers tap the bond market only irregularly, and their issues tend to be small in size, opportunistic in timing, or both. They may be termed “patient traders” with a lower demand for immediate funding. The bond issues of an opportunistic issuer are more likely to be diverse in terms of coupon, maturity and other characteristics. This is because such issuers hit the market only when an attractive financing window opens to meet specific, short-lived investment needs of a particular type of investors. Their bonds are unlikely to trade frequently on the secondary market, not because of shortcomings of the secondary market, but because the bonds themselves are fundamentally short of those prerequisites that “major” bonds have for being actively traded.

For instance, many developing countries faced with weak banking systems and constrained public finances consider financing badly-need infrastructure projects by issuing asset-backed bonds in their capital markets. These bonds, if secured only by the project cash flows or assets of the project, will likely be “minor” issues.

Even in the U.S., only 4 percent of about 400,000 corporate issues outstanding in 1996 traded even once that year¹⁴. This striking reality provides us with two insights into corporate bond markets. First, only a handful of corporate issuers in the market are likely to fall in the category of “major” issuers. Second, in spite of the inherent illiquidity of minor corporate bond issues, the primary market of minor issuers has been playing an enormous role in supplying long-term funds to a country’s private sector.

¹⁴ Mr. Micah S. Green, Executive Vice President of The Bond Market Association in New York, as quoted in the June 27, 1999 issue of the New York Times.

5. Primary Corporate Debt Markets

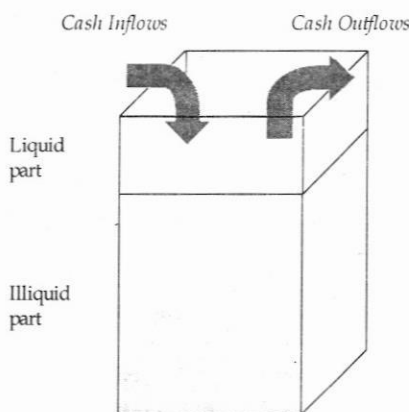
5.1. Primary-market-centric minor corporate issues

Contrary to common understanding, more vital to the development of corporate bond markets is how the issuance of bonds in a primary market can be facilitated than how a liquid secondary market can be developed. This is because of the “buy and hold” strategy legitimately followed by most institutional investors in corporate debt securities.

5.1.1. Buy and hold

The “buy and hold” strategy for corporate debt securities, which is often quoted as a major cause of the illiquidity of their secondary market, is generally legitimate for many institutional investors. Institutional investors purchase corporate bonds, usually in a large lot through public offerings and/or in the secondary market, and hold them to maturity. This strategy is made possible because of the fact that a substantial part of an institutional investor’s investment portfolio does not need to be kept liquid all the time. The money flowing into and out of the portfolio at any given time is relatively marginal, meaning the balance of the portfolio can be made up of relatively illiquid funds, at least for a certain period of time. The actual size of this illiquid component varies and fluctuates, depending on investment objectives, restrictions, the outlook for market conditions, and other factors (see Figure 5).

Figure 5: Liquid/Illiquid Parts of Investment Portfolio



Money that frequently inflows and outflows is marginal to the whole investment portfolio. The rest does not need to stay liquid at all times.

Minor corporate bonds are illiquid and are generally of a lower credit quality, but yield higher returns than government bonds or major corporate bonds. The investor is better off investing this portion of the portfolio in higher yielding bonds, that is, minor corporate bonds at the expense of liquidity and credit quality – to the extent that its risk tolerance parameters permit.

And their illiquidity in turn reinforces “buy and hold” behavior, because if the investor tries to sell them in the secondary market, their realized rate of return will likely get much lower than their yield to maturity due to a large market impact¹⁵.

Only when a country’s capital market development reaches a highly sophisticated level – where institutional

¹⁵ See Footnote 36.

investors such as insurance companies and pension funds are compelled to continuously pursue better performance – will major corporate debt issues and some minor corporate issues be frequently traded in the secondary market. Until that time, most corporate debt securities will trade only when a given investor badly needs to dispose of the security. Consequently, the efficiency of the primary market is the single most critical issue for corporate debt market development in developing countries, save for major corporate issues capable of having some liquid secondary market.

5.1.2. Specific investment needs, specific types of issues

The factor most responsible for the illiquidity of corporate bond issues is their small size. Nevertheless, small issues can also help to most effectively fulfill the specific investment needs of investors.

Different investors have different investment objectives, preferences, capacities and constraints, often due to tax or accounting issues. A single event inside or outside the market will affect the investors' portfolios in different manners, to different degrees, and in different time-frames. Some events will bring about widely divergent impacts on different investors, while others events or developments will have a more uniform effect across the universe of investors. In addition, markets are and will continue to be imperfect.

All these phenomena will create short-lived opportunities for shrewd corporate issuers to selectively exploit, often with specialized debt products. In some cases, investors are willing to pay a premium if particular needs can be satisfied. Conversely, issuers will also be faced with unique or markedly distinct funding needs from time to time, and will consequently need to pay a premium for the fulfillment of these requirements. Evidently, most such deals are limited in size, and once bought by investors on the primary market are the most likely to be held until maturity. Their liquidity is naturally low.

While such minor bonds are highly unlikely to enjoy a liquid secondary market, their pricing in the primary market pricing should be made in reference to the prevailing yield of the benchmark issue – the “on-the-run” issue – with a comparable maturity, rationally adjusted for the vagaries of funding or investment needs. It is this principle that makes primary market activity as a whole coherent, and their economies measurable.

In order to meet these particular needs arising from either temporary or long-lasting market imperfections, investment banks continue to engineer a wide range of debt instruments, in addition to fine-tuning the parameters of individual instruments for specific clients. These include commercial paper, certificates of deposits, floating rate notes, zero-coupon bonds, deep-discount bonds, perpetual bonds, secured or unsecured bonds, convertible bonds, bonds with equity warrants, mortgage-back securities, asset-backed securities, index-linked bonds, medium-term notes, dual-currency bonds, reverse dual currency bonds, and catastrophe bonds.

This diversity and specificity mean that each bond issue has unique contractual features. Some are extremely complex, exposing investors to unique risks, and making crucial the

accurate and comprehensible disclosure of product information about the debt issue¹⁶, unlike stock issues.

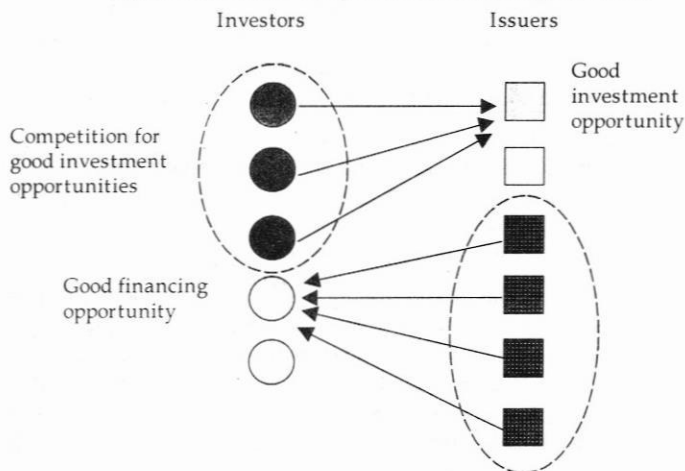
Through these issuing and investing activities exist mainly in the primary market, investors and issuers will continuously match up each other's long-term financial needs in a practically rational way. All in all, an efficient primary market for corporate bonds, even given a marginal secondary market, can still make an unparalleled contribution to a developing economy.

5.1.3. Incessant competition

Both investors and corporate issuers are generating or being faced with specific investment and financing needs under quickly changing business environments in general and financial market conditions in particular. Moreover, developing economies have been more or less financially integrated with international markets. As such, most opportunities for issuers or investors do not last long, and are limited by size in addition to time. In the primary market, investors compete with each other for a finite set of opportunities provided by issuers. The reverse holds true for issuers. This competitive situation is illustrated in Figure 6.

It is under these incessantly competitive circumstances that investors and issuers make investment or financing decisions. As such, anything that hampers their capacity for clear-eyed and nimble decision-making will undermine their confidence in the primary

Figure 6: Incessant Competition for Better Opportunities



In a marketplace, investors are competing with each other for better investment opportunities provided by issuers, and issuers are also competing with each other for better financing opportunities provided by issuers.

¹⁶ See Section 6.1.2 "Enforcement of regulatory disclosure".

market. Therefore, the market needs to be liberalized or deregulated.

5.2. Impediments to primary market development

5.2.1. Statutory restrictions and requirements

Ironically, primary bond markets are more subject to governmental interference than secondary markets. This is because the primary market is the point of entry point for new securities and thus the very first line of investor protection. Statutory restrictions and requirements are usually imposed around the eligibility of market participants or product features, or both. Such government inference often ends up with a merit regime¹⁷.

Table 9 summarizes restrictions and requirements typically imposed on primary corporate bond markets by developing country governments, the possible hidden motives behind the restrictions and requirements, and the potential negative impact of the restrictions and requirements on the development of these markets. Usually, such statutory restrictions have plausible and apparent policy objectives that disguise their negative effects – or the less apparent motives behind the restrictions. These can include protection of the vested interests, preservation of the existing tax base, capital controls, or bureaucratic inefficiency.

Commercial banks in a country may mistakenly feel threatened by the development of a corporate bond market. The bank loan market usually precedes the corporate bond market in a country's financial system by decades or even by centuries. Commercial banks are often tempted to use their political influence to preserve the status quo by restricting the activities of the securities industry. This is despite the fact that a functioning corporate bond market is meant to take a potentially unbearable stress off the country's financial system, and to complement the banking industry for the country's more efficient economic development. Policymakers in developing countries should therefore be aware of risks of administering compromise policies in this regard.

Another potential impediment to the development of a primary market for corporate bonds can be found in a country's securities industry itself. Existing intermediaries like investment banks and brokerage houses may have built up significant vested interests through a banking/brokerage segregation policy like the Glass-Steagall Act in the U.S. They may resist any change to an existing market structure that has effectively barred new and potentially competitive entrants.

Taxes on securities transactions are another common impediment. Taxes not only increase transaction costs, but may fragment the market, depending on investors' tax status. If the country cannot repeal them in the short run, harmonization of tax obligations across the investment community may be a practical solution. Policymakers may also discover that the actual and potential investment community is much more dispersed (and fragmented) than initially assumed.

Lengthy vetting of filed securities registration statements is in all likelihood not an intended restriction. It is a by-product of a statutory action to enforce disclosure-

¹⁷ See Section 6.1.1 "Disclosure system versus merit system"

Table 9: Examples of Statutory Restrictions and Requirements Impeding to Primary Market Development

Restrictive areas	Restrictions & Requirements	Possible, Hidden Motives	Possible Negative Impacts on Debt Market Development
Product features	No short term	To avoid conflicts with banking products.	No reliable/natural anchor for the yield curve, and will distort the yield curve
	Cap on coupon rates	To keep the general level of interest rates artificially low	Will hamper the formation of a yield curve, and dampen supply of and demand for long-term bonds
	No floating rate	To limit competition with bank deposits	Limited hedging tools against interest rate risks
	No/restrictive unsecured bonds	Unsecured bonds may undermine banks' demand for collateral to their loans.	Disadvantageous to new, fast growing companies and non-capital intensive companies
	Bank guarantee	To keep bond issuance under a bank's control	Will limit free risk/return tradeoff
	No forex-linked bonds	Capital control	Will limit hedging tools against interest rate risks
Issuer's eligibility	Credit rating-linked eligibility for bond issuance	To avoid conflict with banks in a lucrative mid-market.	Will limit free risk/return tradeoff; disadvantageous to low-rated companies
	Cap on debt issue amount	To keep bond issuance supplementary to bank loans	Will limit free risk/return tradeoff
	Queuing system	To keep a room for government bond issuance	Will dysfunction demand-supply relationship
Underwriter's eligibility	Too strict or no license for new entrants	Protection of vested interests of existing underwriters	Will limit competition and innovation
Taxation	Withholding tax	Conflict or dilemma with a weak tax collection system	Will fragment the market and limit the liquidity
	Stamp duties		
Others	Ban on swap Ban on futures & options	Bureaucratic investor protection in the absence of financial expertise and well-organized risk management systems at regulatory and corporate levels.	Will limit hedging tools against interest rate risks, and arbitrage activities
	Vetting period of securities registration	Cumbersome and time-consuming. Bureaucratic inefficiency. Banks may benefit from this inefficiency.	Will reduce optimal financing opportunities, and may raise financing costs to issuers

requirements. Nonetheless, an inefficient regulatory action can be seen as a *de facto* statutory restriction in that it prohibits issuers from taking advantage of short-lived financing opportunities. In addition to making vetting operation at the regulatory

authority efficient through staff training and other means, a shelf registration system¹⁸ may be an attractive option.

5.2.2. Mandatory investment in government bonds

The most powerful to protect its own vested interests is the state. A fiscal deficit running state is often tempted to save its deficit financing cost, typically by placing its government bonds with its captive investors such as state provident funds, pension funds, or postal saving funds, and by compelling regulated financial institutions such as insurance companies and commercial banks to purchase them, at sub-market interest rates.

Consequently, long-term interest rates are artificially kept low, and, the yield curve on financial assets in the country is kept nearly flat. Investor will have little incentive to invest in long-term bonds. More surplus funds will flow into bank deposits. Banks will get more willing to extend short-term credits to corporations and to roll them over a long term, discouraging corporations from issuing corporate bonds.

5.2.3. Lack of market infrastructures

Besides statutory restrictions, there are vital market infrastructures whose absence, deficiency or inefficiency will impede the development of a primary market. They include disclosure and information systems, credit rating systems, intermediaries, institutional investors, trading systems and clearing and depository systems. Each of these systems will be discussed later.

5.2.4. Distraction by an equity boom

Another potential impediment is an equity market binge. During a booming equity market, the majority of investors, attracted by the potential for handsome or spectacular capital gains, will become indifferent to the risks inherent in equity investments. At the same time, corporate managers will lavishly float equity or equity-linked securities such as common shares, convertible bonds, and bonds with equity warrants. The capital raised will superficially be low-cost, but only because of the ultimately expensive costs to shareholders are ignored or hidden. Few market participants will bother to contemplate financing with or investing in straight debt securities. No serious need for a primary market of corporate debt will be felt.

In the worst case scenario, corporate managers entrusted with more-than-ample equity capital under loose corporate governance will make poor investments. And losing their traditional clients to the equity market, banks will turn imprudently aggressive in lending. All this will most likely end up with an economy facing excessive capacity, a massive stock of bad loans, and finally crisis.

¹⁸ A shelf registration system allows for the sale of securities on a delayed or continuous basis. Once it registers for an amount that may reasonably be expected to be sold for a predetermined period (say, two years) after the initial date of registration, the issuer and its underwriters are allowed the flexibility to sell the registered securities when they think market conditions are most favorable during that period.

All this makes the development of corporate finance skills on the part of issuing corporations indispensable for the development of a healthy corporate bond market. While training may not be able to tame greed, systematic education on the rational relationship between equities, loans and bonds can reduce the dangers posed to a nascent primary corporate bond market by a booming equity market. For example, the recent, historic equity market boom in the United States did not derail the issuance of corporate debt securities.

5.2.5. Predominance of commercial banks

Commercial banks are by and large far more convenient to industrialists, government officials, politicians, and others as a debt-funding source than a bond market. This often allows commercial banks to be so predominant in a country's financial system that there may be little room left for a corporate bond market. However, banks' credit allocation is generally less transparent than a bond market. Banks' liabilities are largely of short-term, while some of their assets may be long-term loans. Therefore, the over-dependence on the banking system often builds up the systemic risks in the country's financial system. Unless the government takes precautionary measures against such risks, a corporate bond market will have no momentum to evolve.

6. Developmental components

A number of market infrastructures are so essential that the absence, deficiency or inefficiency of such systems may effectively impede the development or functioning of a bond market. They include, but are not limited to, (i) a disclosure and information system, (ii) a credit rating system, (iii) effective bankruptcy laws, (iv) market intermediaries, (v) institutional investors, (vi) a trading system and a clearing and (vii) depository system.

Of these, disclosure and information systems, credit rating systems, and bankruptcy laws are peculiar to non-government bond markets in general and corporate bond markets in particular. The other components are necessary for the functioning of a liquid market in government bonds or *de facto* benchmark bonds, one or the other being the usual antecedent to the development of a corporate bond market.

6.1. Disclosure system and information

There is no question that the fair disclosure of information about an issuer and the securities that it is offering is vital to a functioning of a public market for bonds or equities. It was the arbitrary, incomplete and unsystematic disclosure practices and undemanding, compromising and imprudent investment practices that led to the Asian Crisis, a crisis that scarred nearly every market participant. In addition, it is essential to view disclosure issues in a broader perspective when discussing the development of corporate bond markets, bringing in such issues as (i) the disclosure system versus merit system, (ii) enforcement of regulatory or statutory disclosure, (iii) the promotion of voluntary disclosure, and (iv) the development of information service professions.

6.1.1. Disclosure system versus merit system

Economic development through private investment unequivocally demands the efficient allocation of financial resources. This in turn requires a socioeconomic framework in which the optimal behavior of a diverse universe of investors can be basically assured. A disclosure system is one of key pillars supporting such a framework.

The antithesis of a disclosure system is a merit system, in which the regulatory authorities review the substantive merits of a proposed capital market issue in order to ensure that investors are protected and that the issue is compatible with national economic policy or development schemes. Referring to laws, decrees, or directives, the authorities determine which participants may enter the market and the terms of their involvement, rule on the type of instrument that may be used, and the substantive terms of the instrument (e.g., timing and pricing of the issuance). A merit system in corporate bond markets is exemplified by a queuing system, a coupon rate control, eligibility criteria for issuers, restrictions on bond term, etc. This gives regulators the ability to exercise tremendous power over market outcomes (Wong, 1997).

A merit system, which is operated by a limited number of regulators, induces moral hazards among market participants, including investors, while largely leaving the regulators free from effective accountability. It will impede and ultimately defeat the

development of a sustainably efficient market mechanism.

The merit system or its elements tend to have roots in (i) a policy-based development strategy, (ii) two elements latent in a capital market mechanism, *i.e.*, a direct exposure of inventors to issuer's risks and a socially broad base of fund contributors (investors), and (iii) a populist inclination of democratic political process. It is useful to recognize that the pressure for merit system includes weaknesses in key market infrastructures that many developing countries share. They include weak law-enforcement and court systems, unsophisticated investors, weak intermediaries, weak or nonexistent credit rating systems, weak accounting standards and auditing system, and weak corporate governance. The balanced strengthening of these market infrastructures will ensure the materialization or "upgrading" of a disclosure system in a corporate bond market.

Finally, while it is worth noting that there can be no "100% pure" disclosure system as long as there are governments, an ideal system is one that is reasonably close to being pure disclosure.

6.1.2. Enforcement of regulatory disclosure

The degree of regulatory disclosure required for debt instruments may vary by the history of the issuer and the scope of targeted investors. The existence of an equity market is essentially a prerequisite for the development of a disclosure system for a corporate bond market. The adherence by issuers to International Accounting Standards can help address ambiguities. Disclosure should focus on an issuer's creditworthiness rather than its relative prosperity, and on product information.

Varying degree of required disclosure

The most fundamental regulatory disclosure practice for fund raising through a capital market is the filing of securities registration statements with the relevant authorities. The degree and form of required disclosure through a securities registration statement usually varies, depending on the nature of the securities, whether the issuer is seasoned or unseasoned in the capital market, and whether the issue is public or private. Conventionally, disclosure requirements for a publicly offered equities by new entrants (an initial public offering) are the most stringent, while those for privately placed debt issues by repeat issuers is the simplest.

Equity markets as a prerequisite

A listing of an issuer's stock offers a continuing disclosure mechanism not only for the stock itself but also for the issuer's corporate bonds, regardless of whether the bonds themselves are listed on a public exchange. Through the initial public offering process, a company discloses its operations, financial statements and other required information. Under securities laws and, more importantly, contracts with investors, listed companies are compelled to make regular disclosures as well as occasional disclosures after the occurrence of certain events considered material. This statutorily and/or contractually bound flow of information in reference to the issuer's stock listing can form the basis for the information required for investments in the issuer's debt securities. It is extremely important that disclosure requirements under the listing agreement are adequate and duly

complied with. If they are not complied with, the stock exchange should be able to enforce them¹⁹

International Accounting Standards

There are a number of sources of ambiguity, misunderstanding, or misrepresentation with regard to the issuer's accounting information under developing country settings. These include (i) the consolidation of subsidiaries' accounts; (ii) related party transactions; (iii) contingent liabilities; (iv) unrealized gains and losses from securities investments and forward, swap or futures positions; (v) segment information; and (vi) financial leasing activities. In this respect, the efforts by the International Accounting Standards Committee (IASC) to put in place a comprehensive set of principles for enterprises undertaking cross-border offerings and listings are valuable for developing countries.

Actual willpower and capabilities

Setting high-quality accounting standards in a country is essential. But it is only the first step toward credible disclosure. Accounting standards must be rigorously interpreted and applied. The key issue is the actual level of willpower and the capacity for compliance and enforcement available in a country. And this applies not only to regulators but also auditors and other actors in the private sector.

Credit focus and product information

Disclosure for debt issuance differs from that for equity issuance in certain aspects, including the "prosperity focus" versus credit focus, and product information.

An equity investor focuses more on an issuer's potential for and likelihood of future growth and prosperity. A debt investor is more concerned with the issuer's capacity and willingness to meet its obligations. In the case of asset-backed securities, the characteristics of the assets backing the securities' cash flows need to be disclosed extensively. Credit ratings and reports from rating agencies supplement the disclosure through a listing system.

But the product information required for debt issuance is more complex than that of equity issuance, and varies from issue to issue. Excepting derivatives such as equity warrants, equity issues usually involve common shares whose characteristics are generally well stipulated in the country's company laws or commercial codes. By contrast, there is a wide range of debt instruments, as discussed in Section 5.1.2. In other words, each bond issue has unique contractual features. Some are complex, exposing

¹⁹ In this connection, it is logical that some countries require companies aspiring to publicly issue bonds to have listed their shares on a national stock exchange. However, rules of this kind prevent a project-specific company from publicly issuing bonds to finance its project, because the company often is a special-purpose company but not a public company, and, therefore, disqualifies for listing of its stock. Bonds collateralized with the assets and cash flows without recourse to the issuer would also disqualify for public issuance. These bond structures are of great value to infrastructure and other development projects. Therefore, the rules need some exemptions to facilitate the innovative debt financing techniques that development countries may need for their social infrastructure building.

investors to unique risks. An "exotic" feature, though legally transferable, may make a bond so illiquid that an initial investor would have to hold it to maturity or realize a substantial capital loss to induce a reluctant purchaser.

This makes accurate and comprehensible disclosure of product information of debt issues imperative for a risk and return tradeoff to be correctly and easily recognized by investors. The damaging of investors' interests as a result of inadequate, incorrect or incomprehensible product feature disclosure could severely hamper the development of a functional bond market.

6.1.3. Promotion of voluntary disclosure

On top of regulatory disclosure, efficiency can be dramatically increased through voluntary disclosure. Policymakers in developing countries should promote and facilitate proactive information dissemination activities, especially when driven by private sector initiatives. A credit rating system can be an indispensable element of voluntary disclosure.

There are three major areas identified for voluntary disclosure: (i) corporate governance; (ii) public relations through the media; and (iii) investor relations.

In 1999 the Organization for Economic Cooperation and Development published its Principals of Corporate Governance. These benefited from broad exposure to input from non-OECD countries, the World Bank, the International Monetary Fund, the business sector, investors, trade unions, and other interested parties.²⁰

The issuer can conduct public relations through conventional mass media (press, radio and TV), international electronic media such as Reuters and Bloomberg, and Internet websites. Despite the importance of a cool-eyed assessment of risks and returns, it is nevertheless true that investment banks generally find it easier to place bonds of a well-known issuer, and that such an issuer's yield tends to be lower than one without a household name. The writer-driven nature of the Internet²¹ has made it easier and more

²⁰ The five basic principles are: (1) The Rights of Shareholders: The corporate governance framework should protect shareholders' rights. (2) The Equitable Treatment of Shareholders: The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. (3) The Role of Stakeholders in Corporate Governance: The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. (4) Disclosure and Transparency: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. (5) The Responsibilities of the Board: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of the management by the board, and the board's accountability to the company and the shareholders."

²¹ The Internet platform is writer-driven than reader-driven or watcher-driven. The traditional media, such as TV, radio, and hard copy publication, are basically either reader-driven or watcher-driven. This means that unless you are or your intermediary like a publisher is commercially sure that you can attract a critical mass, you cannot present your views and ideas to the public. Moreover, you have to rely on a host of