Government and Corporate Bond Market Development

Overview of Financial Sector Issues and Analysis Workshop

WB/IFC Securities Markets Group
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Anderson Caputo Silva
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WB-IFC Securities Market Group (GCMSM)

WBG Global Product Group for local securities market development

• Joint WB/IFC Group

• 30+ years of WB/IFC experience in securities markets, products, and institutions -- development and operations

• Specialists include former securities regulators, central bankers, exchange officials, investment bankers, debt managers from developed and emerging markets

• Team has extensive field-based experience in emerging market countries in every region around the world—Asia, Africa, Middle East, Europe, Latin America
Develop Domestic Securities Markets, Mainly Debt

- Provide long term, local currency instruments
- Diversify financial systems
- Reduce financing and investment risks
- Create new investment vehicles

2 Main Product Areas

**Government Bond Markets**
- Reduce government financing risks
- Create market-based pricing and pricing benchmarks, market-oriented monetary policy

**Non-Government Bond Markets**
- Support financing for housing, infrastructure, and private sector investment
- Mobilize savings; provide investments for rapidly growing institutional investors (pensions, insurance)
Crisis Impact

The global crisis is increasing the demand for domestic securities markets:

• Need local investors/markets to offset outflow of foreign investors
• Need to meet financing requirements to offset banking sector downturn
• Need to replace maturing bonds
• Need for companies to raise equity to reduce payment outflows

For our operations:

• Continue development programs. Shift emphasis as needed
• Improve understanding re: ABS instruments
• Advise on new regulatory changes
Government Bond Markets
Issues on Development of Government Bond Markets

- Scope and Lessons for Reform Implementation
- Crisis Impact and Policy Response
- WB Advisory Services (the Gemloc approach)
Scope: A broad array of issues…

<table>
<thead>
<tr>
<th>Broad topics</th>
<th>Specific agenda</th>
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<tbody>
<tr>
<td>Macro and Micro interactions and trade-offs</td>
<td>- Capital controls, international excess liquidity and convertibility</td>
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<td>- Financial markets taxation structure</td>
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<td>Primary Markets</td>
<td>- Debt management strategy and issuance policy</td>
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<td>- Placement mechanisms and organization</td>
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<td>Money Markets</td>
<td>- Repo markets</td>
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<td>- Operational liquidity management</td>
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<td>Secondary and Derivatives Markets</td>
<td>- Exchange and OTC markets</td>
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<td>- Interactions between markets and development sequence</td>
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<td>- Valuation schemes</td>
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<td>Participants and Investor Base</td>
<td>- Foreign and local investor base</td>
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<td>- Strategies for diversification</td>
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<td>- Prudential regulations</td>
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<td>Custody, Clearance, and Settlement</td>
<td>- Local and International Central Securities Depositories (CSD)</td>
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<td>- Risk management upgrades</td>
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<td>Regulations for Debt Markets</td>
<td>- Systemic risk and investor protection</td>
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<td>- Enforcement capabilities</td>
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Identifying bottlenecks is an issue…

Sound Principles

Sound Practices

Country Specific Issues

Design of a “tailor-made” reform program

…but the major challenges seem to be tailoring programs to specific requirements, sequencing and coordinating their implementation.
Two key challenges for effective implementation

From diagnostics to reform implementation: insights from WB experience (12 country cases)

- High complexity – reform programs affect numerous actors and require creation of sound market infrastructure (trading, settlement, and information systems)

- Extensive interaction between various aspects of debt markets \(\rightarrow\) path dependence

• Scope and Lessons for Reform Implementation

• Crisis Impact and Policy Response

• WB Advisory Services
  (the Gemloc approach)
• Shift from credit to liquidity crisis—some EMs hit hard

• Global economic downturn – taking center stage and basically hitting all EMs

• These waves of contagion have affected balance of demand and supply in bond markets
Crisis Contagion: Refinancing Risks

Deleveraging, EM currency depreciation…
...sudden stop of flows and worsening money market conditions are affecting EM issuers access and refinancing risks
Growing Fiscal Deficits

- Fiscal conditions are deteriorating across developed and EM economies
- Ongoing and expected increase in supply of government bonds – with clear implications to well functioning of bond markets
Impact on local govt. bond yields

- While yields sharply increased in the weeks after the Lehman outbreak, the overall impact in most markets was a reduction.
- Easing monetary cycles and flight to quality
Crisis Impact on Building Blocks for Local Bond Markets

- **Money market**—activities are slow to recover and in need of arrangements to reduce counterparty risk
- **Investor Base**
  - Escalation of buy and hold behavior
  - Shifts in composition of govt securities holders
Crisis Impact: Primary Markets

• International markets virtually closed to EM issuers

In domestic markets…

• Countries were initially pressured to shorten duration of new debt

• Several undersubscribed auctions or had to change issuance schedule

• Obligations of primary dealers to submit minimum bids and guarantee demand in govt auctions became difficult
Crisis Impact: Secondary Markets

- Liquidity has dropped substantially
- Increased cost of funds, high counterparty risk and difficult access to securities lending hurt capacity to provide bid/ask spreads and guarantee minimum turnover
Policy Measures

- Develop Repo Markets
- Reduce Excessive Supply Pressures by Assessing Funding Alternatives
- Improve Issuance Practices
- Consider Active Liability Management Practices
- Adjust Primary Dealers Programs
- Improve Price Dissemination Schemes
• Upgrade Clearing and Settlement Infrastructure
• Address Other Sources of Transaction Costs
• Do Not Forget the Broader Development Agenda
• Scope and Lessons for Reform Implementation
• Crisis Impact and Policy Response
• WB Advisory Services (the Gemloc approach)
Gemloc Program

• New World Bank Group initiative combining comparative advantages of WBG and private sector

• 3 separate but synergistic pillars with 3 commercial partners:
  – Investment management (PIMCO)
  – Index/investability indicators (Markit + Crisil)
  – Advisory services (World Bank)

• Creates market-based incentives for policy reforms
  – Strengthen market operations
  – Increase investability score/GEMX weight
  – Attract more foreign/domestic investment
### Gemloc Eligible Countries: Advisory Services

34 countries currently eligible

<table>
<thead>
<tr>
<th>Gemloc Phase 1</th>
<th>Gemloc eligible</th>
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<tbody>
<tr>
<td>Brazil</td>
<td>Argentina</td>
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<td>Chile</td>
<td>Costa Rica</td>
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<td>China</td>
<td>Croatia</td>
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<td>Colombia</td>
<td>Kazakhstan</td>
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<td>Egypt</td>
<td>Kenya</td>
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<td>Hungary</td>
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<td>India</td>
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<td>Indonesia</td>
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<td>Sri Lanka</td>
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<td>Mexico</td>
<td>Tunisia</td>
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<td>Morocco</td>
<td>Ukraine</td>
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<td>Nigeria</td>
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<td>Peru</td>
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<td>Phillipines</td>
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<td>Poland</td>
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<td>Russia</td>
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<td>Slovakia</td>
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<td>South Africa</td>
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<td>Thailand</td>
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<td>Turkey</td>
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## GEMX Index: Investability Indicators

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<tr>
<th>Category</th>
<th>Indicator</th>
<th>Weight</th>
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<tr>
<td><strong>A. Access</strong></td>
<td>Access to securities markets</td>
<td>13%</td>
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<td>Access to money markets</td>
<td>8%</td>
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<td></td>
<td>Access to derivative markets</td>
<td>4%</td>
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<td>Effective rate of taxation for fund</td>
<td>10%</td>
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<td><strong>B. Liquidity</strong></td>
<td>Turnover ratio</td>
<td>9%</td>
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<td>Bid-Ask Spread</td>
<td>11%</td>
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<td>Benchmark yield curve</td>
<td>2.5%</td>
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<td>Centralized bond pricing</td>
<td>2.5%</td>
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<td>Institutional investor base</td>
<td>10%</td>
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<td><strong>C. Infrastructure</strong></td>
<td>Regulatory quality</td>
<td>10%</td>
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<td></td>
<td>Creditor rights</td>
<td>5%</td>
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<td>Asset servicing</td>
<td>7.5%</td>
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<td>Clearing and settlement</td>
<td>5%</td>
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<td>Safekeeping safety/soundness</td>
<td>2.5%</td>
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Selected Advisory Services Operations

Country Specific Programs
- Egypt, Nigeria
- Add’l to follow

Peer Group Dialogue
- March 31\textsuperscript{st}, first peer group dialogue on crisis challenges in the top emerging bond markets. 9 countries. Via teleconference.
- More peer groups planned

KM Products
- Gemloc survey on development obstacles (22 countries)
- Research papers, policy notes
- Websites: Gemloc advisory services, Peer Group
Non-Government Bond Markets
Growing Market Demand

• Finance housing, infrastructure, capital investment
• Provide investments for rapidly growing institutions (pension funds, insurance companies)
• Support economic growth with stability
• Address crisis demands
Financial assets are dominated by bank loans and public equities

Note: 1. Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru.
   Asia: China, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Thailand.
   Emerging Europe: Croatia, Czech Republic, Hungary, Poland, Russian Federation, Slovak Republic, Turkey.
2. GDP : Czech Republic, Indonesia, Korea, Singapore (2007).
5. Private Credit: Philippines(2007); Chile, Pakistan (Q2-2008); Argentina, Brazil, India, Korea, Malaysia, Turkey (Q3-2008).
Source: BIS, World Bank, IMF IFS
Government Bonds Dominate

Note: 2008 data as of September.
Source: BIS
Small Non-Government Bond Markets

EM Domestic Debt Securities Outstanding
(% of GDP, 2008)

Source: BIS, World Bank WDI
Key Challenges to Bond Transactions

Transactions are obstructed by several factors

**Investors**
- Credit risk concerns
- Limiting investment guidelines
- Performance benchmarks

**Issuers**
- Onerous issuance procedures
- High costs
- Reluctance to disclose
- Banks more attractive
Regulations

Credit Rating Agencies

Marketplace (Trading/Settlement/Depositories)

Issuers

Intermediaries

Investors (pensions/insurance)

Need comprehensive programs to address full range of issues
GCMSM’s Programs: Comprehensive Approach

Comprehensive programs to address range of issues
Link enabling environment with transactions
Draw on full WB/IFC tools and perspectives
Unique Role of Transactions Component

Improve Enabling Environment
Regulations, market infrastructure, market participants

Facilitate Transactions
Hands-on support to issuers/intermediaries
Knowledge of specific challenges on the ground
Yardstick for program success

Transactions

Technical Assistance
ESMID-Africa (Pilot)

Comprehensive approach to developing local bond markets

- 3 year, $5.5 million program funded by SIDA
- Transaction support as catalyst and validates success in enabling environment work
- Sub-regional program for East Africa
- Special focus on long-term funding for housing and infrastructure
- Expanding globally

Advice to Regulators on Legal and Regulatory Framework

- Improve approval process
- Reduce costs
- Framework for new products

Transactions Support

- Active support to issuers and intermediaries for replicable transactions
- Introduce new & innovative products

Capacity Building

- Certification/Licensing
- Training
- Develop regional provider

Strengthening Market Infrastructure

- Market Structure
- Clearing & Settlement
- Transparency & Information Dissemination

Regionalization

- Broadening & deepening markets
- Cross border issues
ESMID Africa: Pilot Program Key Achievements

• **Comprehensive assessments and implementation roadmaps**
  – Recommendations for improving legal/regulatory framework for bond issuance
  – Roadmap for flexible market model and OTC trading
  – Regional harmonization based on a mutual recognition regime and system compatibility

• **Regional training institute and licensing structure**
  – Piloted and developed regional training curriculum
  – Trained over 130 market participants and 25 local trainers
  – Assisted regulators define regional licensing framework for professionals

• **Pipeline of potential transactions**
  – Supporting promising issuers in infrastructure, housing, and microfinance sectors
    (Nairobi City Water & Sewage, Kenya Airport Authority, Kigali City Bus Terminal)

• **Widespread local and regional support**
  – Reached out to over 700 local actors; cultivated strong relationships with key stakeholders
  – Becoming a recognized authority on capital market development, playing a key role in policy dialogue on financial sector reforms
Importance of ABS

DEMAND

- Growing domestic institutional investor base
- Need to diversify away from sovereign risk, but limited blue chips in which to invest
- Regulations requiring local currency investments and minimum acceptable ratings

SUPPLY

- Increased focus by borrowers on matching assets and liabilities
- Increased need for finance in areas with assets/receivables to put to work
- Volatile cross-border financing
- Relatively low domestic nominal interest rates

ABS can help fill this gap
• Flows of underlying assets/receivables pay off bondholders
• Bond credit determined by performance of underlying asset flows
• Helps address:
  – Credit concerns/provides quality assets
  – Small balance sheet constraints
  – Funding and regulatory constraints (Fis)
• Supports local bond market growth
  – More issuers can participate
  – More investors can participate
Securitization at Work

The quality of the underlying assets determines the quality of the bond (ABS) issued.

Possible Underlying Assets:
- Infrastructure receivables (toll roads)
- Mortgages, consumer, auto, other loans
- Leasing receivables
- Medical receivables

If Flows Are:
- Reliable
- Standardized
- Performing
Crisis Impact

- Increased demand for assistance
- Need to educate about ABS
- Need to advise on revised regulations
ABS and the Crisis

Key issues

Underlying Loans

• Originate and distribute confused incentives
• Poor underwriting standards/weak credits
• Bad performance history
• Unregulated originators

Slicing and dicing

• Complicated structures obscured risk
• Rating agencies: difficult to assess

Investors with ST funding

• Solid credits/regulated originators/performance history
• Simple structures. More use of covered bonds
• Spurred intensive rethinking of the regulatory landscape

• From philosophical to technical issues:
  – Update the framework to reflect marketplace realities (who’s regulated, how, by whom?)
  – Revise incentives/compensation structures (reduce risk taking, individual profits, socializing losses)
  – Question the market model
  – Revise capital and leverage calculations

• Emerging market countries, and we, will need to wrestle with new approaches in hopes of reducing financial crises

• But first wait for the dust to settle