



WP/07/288

IMF Working Paper

Equity and Private Debt Markets in Central America, Panama, and the Dominican Republic

*Hemant Shah, Ana Carvajal,
Geoffrey Bannister, Jorge Chan-Lau, and
Ivan Guerra*

IMF Working Paper

Monetary and Capital Markets and Western Hemisphere Departments

Equity and Private Debt Markets in Central America, Panama, and the Dominican Republic

Prepared by Hemant Shah, Ana Carvajal, Geoffrey Bannister, Jorge Chan-Lau, and Ivan Guerra

Authorized for distribution by Ceyla Pazarbasioglu and Dominique Desruelle

December 2007

Abstract

This Working Paper should not be reported as representing the views of the IMF.

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

This study focuses on equity, private debt, and asset-backed securities markets in Central America. These markets are generally under-developed throughout the region due to several structural problems, economic and political factors, and weaknesses in regulation and in institutional investor base. The paper identifies key country-specific recommendations to strengthen securities laws, regulatory oversight, market infrastructure, investor base, and new products such as asset-backed securities. Despite these efforts, developing seven viable private capital markets is a difficult goal. The paper thus also explores the benefits and difficulties of creating a single capital market in a region still short of full economic integration.

JEL Classification Numbers: G21, G23, G28, K22, N26

Keywords: Central America; equity; debt; securitization; financial integration; capital market development; securities regulation; Costa Rica; Dominican Republic; El Salvador; Guatemala, Honduras; Nicaragua, Panama

Authors' E-Mail Addresses: hshah@imf.org; acarvajal@imf.org; gbannister@imf.org; jchanlau@ifc.org; iguerra@imf.org

Contents	Page
Executive Summary	5
I. Overview of Financial Sector	6
II. Regulation and Supervision of Securities Markets	9
A. Basic Legal and Regulatory Framework for Securities Markets	9
B. Structure of Securities Regulators.....	11
C. Authority, Staffing, Budget, and Quality of Enforcement	13
III. Market Infrastructure	14
A. Securities Exchanges.....	14
B. Clearing, Settlement, and Depository Services.....	16
C. Rating Agencies and Price Vendors.....	17
IV. Business Environment and the Framework for Public Issuance	20
A. Business Environment.....	20
B. The Regulatory Framework for Public Issuance.....	23
V. Institutional Investors.....	32
VI. Equity Markets.....	35
A. Current Status.....	35
B. Incentives and Obstacles to Equity Issuance.....	39
VII. Corporate Debt Markets	42
A. Current Status.....	42
B. Incentives for Corporate Bond Issuance and Investment.....	45
VIII. Asset-Backed Securities.....	47
A. Current Status.....	47
IX. Scope for Developing Capital Markets In the Region.....	49
A. The Case for Policy Action.....	49
B. Limited scope for Developing Individual Country Capital Markets.....	50
C. Scope for Regional Integration of Private Capital Markets	51
X. Specific Recommendations.....	58
A. Securities Laws and Regulation.....	58
B. Securities Regulators.....	61
C. Developing Institutional and Retail Investor Bases	61
D. Development of Equity Markets	62
E. Market Infrastructure.....	62
F. Broader Policy Measures	63

Reference	130
-----------------	-----

Tables

1. Central America: Financial System Snapshot, as of end 2006	7
2. Central America: Securities Markets Basic Legal and Regulatory Framework	10
3. Central America: Structure and Resources of Securities Regulators	12
4. Central America: Securities Exchanges	15
5. Central America: Clearing and Settlement Systems	19
6. Central America: Indicators of Ease of Doing Business, 2006	22
7. Central America: Taxation of Income from Securities	24
8. Central America: Equity Issuers Registration Requirements	27
9. Central America: Equity Issuers On-Going Disclosure Requirements	28
10. Central America: Corporate Governance	29
11. Central America: Debt Issuers Registration Requirements	30
12. Central America: Debt Issuers On-Going Disclosure Requirements	31
13. Central America: Regulation of Mutual and Pension Funds	33
14. Central America: Pension Funds	34
15. Central America: Mutual Funds	36
16. Central America: Equity Market Capitalization and Turnover	37
17. Central America: Equity Issuance and Delisting	38
18. Size of Emerging Capital Markets	40
19. Central America: Corporate Debt Outstanding and Turnover	43
20. Central America: Corporate Debt Issuance and Delisting	44
21. Central America: Summary of Recommendations	59
22. Costa Rica: Financial Intermediaries	64
23. Costa Rica: Mutual and Pension Funds	64
24. Costa Rica: Equity Markets	69
25. Costa Rica: Debt Markets	70
26. Dominican Republic: Financial Intermediaries	78
27. Dominican Republic: Mutual and Pension Funds	79
28. Dominican Republic: Debt Markets	81
29. El Salvador: Financial Intermediaries	87
30. El Salvador: Mutual and Pension Funds	91
31. El Salvador: Equity Markets	91
32. El Salvador: Debt Markets	93
33. Guatemala: Financial Intermediaries	99
34. Guatemala: Debt Markets	102
35. Honduras: Financial Intermediaries	107
36. Honduras: Mutual and Pension Funds	109
37. Honduras: Debt Markets	110
38. Nicaragua: Financial Intermediaries	115
39. Nicaragua: Debt Markets	118

Boxes

1: Steps Toward Integration of Regional Capital Market	53
2. Integration in Nordic/Baltic Securities Market	54

Appendixes

1. Country Studies: Costa Rica	64
2. Country Studies: Dominican Republic	75
3. Country Studies: El Salvador	87
4. Country Studies: Guatemala	98
5. Country Studies: Honduras	106
6. Country Studies: Nicaragua	114
7. Country Studies: Panama	122

EXECUTIVE SUMMARY

This study focuses on equity, private debt, and asset-backed securities markets in the seven countries in the region. It follows a similar study for public debt markets undertaken in 2006. The focus of the paper is primarily regional, with limited treatment of country-specific issues.

Not surprisingly, we find that private capital markets in several countries in the region are under-developed in terms of size, liquidity, and number of issues relative to some regional peers, many countries of a similar size, and generally compared with the more advanced emerging markets. *Equity* markets exist only in three of the seven countries and are shrinking in some of them; private *debt* markets are even smaller, and asset-backed securitization is at an incipient stage in six of the seven countries. Collectively private capital markets play an extremely limited role in financial intermediation, price discovery, or risk diversification. While these problems do not constrain financing of private sector projects, they do limit the efficiency of such financing in terms of risk-sharing and diversification.

Under-developed capital markets create poor valuations and discontinuous growth prospects for regional businesses, and difficulties of exit for principal shareholders. The consequences may be worse for institutional and retail investors, who may be unable to meaningfully diversify their investment portfolios. Systemically, such under-development create strategic weaknesses in the banking system, and complicate important public policy choices, particularly regarding pension reforms, if pension funds must invest predominantly in limited domestic markets.

Several historic economic, structural, and political conditions have dampened both supply and demand for private securities. The relatively small size of regional businesses, pervasive family ownership, aversion of principal owners to minority partners, and tax avoidance all limit security issuance. Poor corporate governance, investor protection, and memories of political and financial crises limit retail investment in private securities, while institutional investors remain far smaller than the banking system.

Basic securities laws and regulation have important gaps in many countries. Securities regulation has been weak, indeed nonexistent in some countries, with larger gaps in development of enabling legal framework for mutual funds, pension funds, and asset-backed securities. Where pension funds exist, there are important limitations on their investment regime.

We find no simple, single solutions to the development of regional capital markets. Rather, development of securities markets would require comprehensive efforts from both the public and private sector to resolve several country-specific problems. The paper outlines several recommendations to strengthen securities laws, regulation, and regulators; simplify and expedite the issuance approval process; develop the retail and institutional investor base; and strengthen trading infrastructure. While it is difficult to generalize across seven countries, the key priorities would include removal of obstacles to asset-backed securities markets (ABS); completing the enabling legal framework for mutual funds and private pension funds; and simplifying approval of private security issuance.

Even with these reforms, countries in the region may find it very difficult to create a viable national stock market in the foreseeable future. The best option for the four less developed capital markets may lie in adopting one of the other markets in the region as their own. And it would be challenging for the other three to reach a viable size, offer adequate diversification opportunities, attract foreign investors, or retain top domestic issuers and investors. Thus, the region as a whole may wish to seriously consider a medium-term goal of developing a regional securities market, balancing the potential benefits from economies of scale with the implementation and coordination costs. Given the incomplete economic integration of the region, this is a fairly complex challenge that would merit an in-depth study of its economic and political feasibility. The paper provides an early assessment of the required steps needed for such integration. Either way, even with all the efforts recommended in this paper, the prospects of developing seven private capital markets or a regional one to the level observed in the large emerging markets would remain difficult..

The paper is structured as follows. This main paper provides a regional summary, while the seven appendices focus on individual countries. The next sections of this main paper look at the overview of the financial sector; regulation of securities markets; market infrastructure; business environment, corporate governance and investor protection; issues relating to equity markets, debt markets, and asset backed securities; and regional integration. The last two sections offer conclusions and recommendations.

I. OVERVIEW OF FINANCIAL SECTOR

Banks and their affiliates dominate the financial system. While growing rapidly, financial intermediation in Central America, Panama, and the Dominican Republic (“Central America” or “region” in the rest of the paper) continues to take place mainly through the banking sector. Assets in the banking system are significantly larger (80 percent of regional GDP) than those of the pension funds, insurers and mutual funds (9 percent). Bank lending to the private sector (ranging from 19 to 82 percent of GDP across countries, and 42 percent of the region) significantly outstrips equity and bond financing provided by capital markets (12 and 6 percent of GDP respectively (Table 1)). Until recently, the banking system has been dominated by regional financial conglomerates. With the recent acquisitions of several major regional banks,¹ global financial institutions have acquired an important market share and regional presence.

¹ Citibank of Grupo Cuscatlan (2006), Banco Uno (2006), HSBC of Banistmo (2006), and GE Consumer Finance of Banco de América Central—BAC (2005).

Table 1. Central America: Financial System Snapshot, as of end 2006

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama	Total
Number of:								
Commercial Banks	17	13	12	23	16	7	87	175
Insurance Companies	1	32	17	18	14	5	18	105
Mutual funds	128	4	8				23	163
Pension Funds	24	7	2		6		2	41
Stock Exchanges	1	1	1	2			1	6
Stock Brokers	20	10	13	21	8	6	34	112
Size (in percent of GDP)								
Commercial Banks:								
Total Assets	57.2	33.2	64.1	38.6	90.8	57.4	221.1	80.4
Claims on Private Sector	39.3	19.0	43.5	26.8	47.6	33.2	81.7	41.6
Total Deposits	13.2	20.6	41.7	28.7	56.7	41.1	155.0	51.0
Assets under Management:								
Insurance Companies	0.0	0.0	2.0	1.3	3.3	1.8	4.9	1.9
Mutual Funds 1/	7.3	0.0	2.9	0.0	0.0	0.0	2.9	1.5
Pension Funds	7.0	2.1	18.5	0.0	19.2	0.0	0.4	5.4
Equity Market Capitalization	8.6	0.0	41.4	0.0	0.0	0.0	39.8	11.8
Corporate Debt Outstanding	23.3	0.6	4.4	0.4	0.0	0.4	12.1	6.0
Memo:								
Annual CPI inflation (percent)	11.5	7.6	4.6	6.6	5.6	9.4	2.5	
Deposit interest rate (percent)	9.8	9.8	4.4	4.5	9.3	4.9	3.8	
Gross Domestic Product (US\$ million)	21,384	31,600	18,654	35,304	8,981	5,369	17,113	138,405
Total public debt (US\$ million)	10,011	12,892	6,637	8,737	3,511	8,046	10,452	60,285
of which: central government	7,405	8,379	6,187	6,613	3,369	5,760	10,452	48,166
of which: central bank	2,606	4,513	450	2,123	142	2,286		12,120
of which: eurobonds/external issuance	2,405	7,266	3,290	3,957	3,021	4,527	7,788	32,254

Source: IMF/MCM survey, IMF IFS, Central Banks, Ministries of Finance, country regulators, and local stock exchanges

1/ For El Salvador, the figure refers to administradoras de cartera which are not technically mutual funds

The under-development of capital markets reflects a common pattern among developing countries, and certain business characteristics in Central America that suppress securities issuance. It is commonplace in small and developing countries for banks to dominate financial intermediation, and for capital markets to develop later and more slowly. But the current state of under-development of the Central American securities markets also reflects the small size of most regional businesses, the dominance of family-owned businesses and conglomerates, and gaps in corporate governance and disclosure within the region. These conditions generate informational asymmetries that may justify the observable preferences in corporate financing. Bank financing is preferred by a wide margin, as banks may have advantages in monitoring the use of funds by borrowers.² The regional conglomerates also prefer financing through the ‘house’ bank rather than from the market for reasons of corporate control. Corporate debt issuance ranks a distant second and equity financing ranks last, in concordance with standard corporate finance theory.³ Moreover, a good part of the current very limited equity issuance is also driven by regulation and overstates the true preference for equity funding. For example, in case of banks in El Salvador, equity listings are mandatory. Equity shares, however, are usually placed with conglomerate shareholders and seldom change hands.

In addition to limited corporate financing through the capital markets, there is little use of asset-backed securitization in the region. Except for Panama and Costa Rica, there has been no meaningful on-shore securitization of assets in the region. This reflects both the relatively liquid state of many of the region’s banking systems, gaps in the facilitating regulatory and tax framework, and insufficient standardization of underlying assets, particularly mortgages.

The under-development of institutional investors inhibits long term demand for securities and capital market development. In developed, and increasingly in emerging markets, insurers, mutual funds, and pension funds are the major and natural investors in tradable securities. In Central America, for a variety of reasons, these investors are as yet poorly developed. With an aggregate resource envelope of barely 9 percent of the regional GDP, they lack the resources to contribute meaningfully to demand for capital market securities and thus to capital market development.

Lack of confidence in the enforcement and real value of financial contracts are major constraints on retail demand. There have been several episodes of financial distress in the region, including bank failures (e.g., in Dominican Republic, Honduras, Guatemala, and Nicaragua); the mutual fund crisis in Costa Rica; sovereign debt problems in Nicaragua and Dominican Republic. The region has also experienced significant political strife. These factors have generally weakened confidence in regional currencies and regional financial securities. Most countries face problems with the execution of collateral and lack effective out-of-court settlements. Judicial proceedings are often lengthy, unpredictable, and biased, with

² Diamond, D., (1984). Indeed, anecdotal evidence suggests that borrowers may provide banks with accounting data different from those reported for tax purposes.

³ Myers, S.C., (1984).

overburdened courts that lack specialized judges. In addition, bankruptcy laws are outdated and need to be modernized.

The low number and volume of issuances also reduces possibilities of meaningful diversification for regional retail investors. At the same time, even small investors are generally aware of and able to access investment opportunities abroad. The resulting weaknesses in the retail demand for regional private securities can be overcome only gradually through improved confidence in financial system, better supervision and disclosure, and an increased supply of investible securities.

II. REGULATION AND SUPERVISION OF SECURITIES MARKETS

A. Basic Legal and Regulatory Framework for Securities Markets

Securities regulation needs to be developed in several key areas and in most countries. The laws relating to securities markets are still being promulgated, completed, or modernized in several countries. There are significant shortcomings in several areas, including corporate governance for listed companies, powers of the regulator, division of oversight between the regulator and the exchanges, and the regulators' ability to cooperate with other jurisdictions. In addition, many countries need to introduce or develop the legal framework for newer topics or products. The more important gaps include ABS (in El Salvador and Guatemala, and to some extent in the Dominican Republic and Honduras) and mutual funds (El Salvador and Guatemala) (Table 2). Enabling regulations in many areas remain to be introduced. Guatemala and Nicaragua have the farthest to go to complete the basic legal framework for securities. The former has yet to pass a modern basic securities market law, and the latter just approved a new Securities Law in 2006, but has yet to enact all the regulations necessary for its implementation.

The process for authorization of securities issuance needs to be improved and streamlined throughout the region. Approval by regulators for issuance tends to concentrate on the more formal requirements and less on material issues that can affect transparency and the value of the securities. In terms of timeliness of approval, regulators frequently do not provide comments all at once. Market participants also complain of inconsistent responses across time and over similar issues. The gaps in coordination between the regulator and the exchange in the process of authorization and listing also leads to unnecessary delays. Thus, the authorization process ends up being protracted (often six months or more), costly and uncertain, creating an incentive in favor of bank loans rather than securities issuance.

Some regulators have taken measures to alleviate these problems. Useful approaches include establishing deadlines for all comments (Costa Rica), and for the authorization of an issue (Costa Rica, El Salvador, and Panama) and establishing fast track approval (basically a "shelf" registration regime) for certain types of bond issues (Costa Rica, and in Panama for commercial paper).

Table 2. Central America: Securities Markets Basic Legal and Regulatory Framework

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Regulator							
Legal framework	Yes	Yes	Yes	No, it is only a registry	Yes	Yes	Yes
Corporate governance							
Legal framework	Very basic	Very basic	Very basic	Very basic	Very basic	Very basic	Very basic
Code of corporate governance for listed companies	Yes	No	No	No	Yes	No	Yes
Mutual funds							
Legal framework	Yes	Yes	No 1/	No 2/	Yes	Yes	Yes
Complimentary regulations	Yes	Yes?	No	No	Yes?	No	Yes
Private pension funds							
Legal framework	Yes	Yes	Yes	?	Yes, but only for public pensions?	Yes, but not implemented	Yes
Complimentary regulations	Yes	Yes	Yes	?	Yes?	No	Yes?
Asset-backed securities							
Legal framework	Yes	Yes, but limited	No	No	Yes, but limited	Yes	Yes
Complimentary regulations	Yes	No?	No	No	Yes	No	No 3/
Trust							
Legal framework	Yes	No	Yes	Yes	Yes	No?	Yes

Source: IMF/MCM survey

1/ Brokerage houses administer 'carteras de inversión' which are poorly-regulated quasi mutual funds.

2/ The legal framework includes 'sociedades de inversión' which are poorly-regulated quasi mutual funds.

3/ Participants do not consider it an impediment.

B. Structure of Securities Regulators

The nature and structure of securities regulators varies across the region. Costa Rica, Dominican Republic, El Salvador, and Panama have specialized regulators for securities markets.⁴ In Honduras and Nicaragua securities regulators are housed within a regulatory unit that oversees the whole financial sector. Guatemala does not have a securities regulator, but only a securities registry. Five of the regulators have a Governing Board and a Superintendent in charge of day to day operations, while Panama only has a board, with no separate managerial figure (Table 3).

Regional securities regulators enjoy only limited independence and self-funding. In most countries (with the exception of Honduras and Panama), the Minister of Finance and/or the Governor/President of the central bank are represented in the Governing Board of the regulatory agencies; moreover in the cases of Costa Rica and Nicaragua they themselves are members of the Board⁵. While not uncommon internationally, such representation could reduce the independence of the regulator. Most regulators are also largely dependent on public funding either through the Ministry of Finance (Guatemala, El Salvador, Honduras, and Panama) or the central bank (Costa Rica, the Dominican Republic, and Nicaragua). Levies on market participants provide only a fraction of the regulator's budget, with the public sources accounting for 75–100 percent of the funding in Guatemala, El Salvador, Costa Rica, and Nicaragua. In the Dominican Republic, the regulator is almost entirely financed by a special fund established by the central bank. Such dependence on public funding tends to restrict independence of securities regulators, especially relative to bank regulators that tend to be better funded from market levies.

Securities regulators are also restricted by the application of civil service rules. In Guatemala, Honduras, and Panama, securities regulators are constrained to varying extents by regulations governing staffing and salaries, which limit their ability to hire qualified personnel, as private sector salaries tend to be significantly higher. In El Salvador, the budget of securities regulator and personnel contracts are subject to approval of the Ministry of Finance. Costa Rican and Dominican Republic regulators enjoy the highest level of autonomy within the region.

⁴ Costa Rica is a hybrid case in that three Superintendencies (for Banking, Pensions and Securities) share the same Governing Board. While this paper does not discuss it fully, the presence of several financial conglomerates makes effective consolidated supervision of financial sector an important issue.

⁵ In Nicaragua only the Governor of the Central bank is board member since a recent legal amendment eliminated the participation of the Minister of Finance.

Table 3. Central America: Structure and Resources of Securities Regulators

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Name	Superintendencia General de Valores	Superintendencia de Valores de la Republica Dominicana	Superintendencia de Valores	Registrador del Mercado de Valores	Comisión Nacional de Bancos y Seguros	Superintendencia de Bancos y de Otras Instituciones Financieras	Comisión Nacional de Valores
Nature	Dependency of the Central Bank	Separate legal entity	Separate legal entity	Dependency of the Central Government A Registrador	Dependency of the Presidency	Separate legal entity	Separate legal entity
Governance structure	Board and Superintendente	Board and Superintendente	Board and Superintendente		Board and Superintendente	Board and Superintendente	Board only
Composition of the Board	7 members, including 5 from private sector, the MoF and the Pres of the CB.	7 members, including the Superintendente, 1 representative of the CB, 1 of the MoF and 4 from the private sector.	5 members, including the Superintendente, 1 from the MoF; 1 from the CB; 1 from shortlist from the unions, 1 from shortlist from professional associations.	There is no board	3 members, one acts as President of the CNBS.	6 members, including 4 from private sector, the Superintendente de bancos, and the Presidente of the CB.	3 members from private sector.
Funding	Central Bank: 80% Fees on participants: 20%	Central Bank	Central Government: 90% Fees on participants: 10%	Central Government	Central Government: 50%, Fees on participants: 50%	Central Bank: 25%; Fees on participants: 75%	Central Government: 40% Fees on participants: 60%
Budget	Central Bank Budget	Separate budget	Central Government budget	Central Government budget	Central Government budget	Separate budget	Central Government Budget
Funding for 2006 (US\$ million)	4.01	3.86	1.57	?	?	?	1.23
Staff for 2006	109	115	45	5	3?	7	42

Source: IMF/MCM Survey

C. Authority, Staffing, Budget, and Quality of Enforcement

The regulator's authority varies considerably across the region. Several regulators face limitations on their legal authority to regulate and supervise securities markets. The most critical case is that of Guatemala, where the registrar has no material powers to regulate, supervise or enforce. In Honduras and Nicaragua, regulators believe the law provides them with sufficient powers, but these are so far untested. In other countries, there are important limitations on the powers of regulation and supervision. Common areas of weaknesses include: (i) the disciplinary framework for regulators (e.g., in Costa Rica, the Dominican Republic, El Salvador, and Panama), where there is a need to better define civil and criminal misconduct, manipulation of markets, and insider trading and widen the range of sanctions; and (ii) the power to share confidential information and cooperate with foreign regulators (Panama, the Dominican Republic, and Costa Rica), which can affect regional integration efforts. Some of the regulators have limited powers over rating agencies and external auditors. Both are cases where international best practices have experienced considerable changes in recent years.

The staff size and budgets of securities regulators also vary considerably. In terms of resources, it is possible to identify three tiers: 1) Guatemala, Honduras, and Nicaragua, with a staff of less than 10; 2) El Salvador and Panama with a staff of around 40 and a budget of around US\$1.5 million; and 3) Costa Rica, and the Dominican Republic, with personnel in the 100's and budgets of around US\$4 million.

The quality of supervision and enforcement varies, given the level of market development, authority, supervisory capacity, and resource constraints. There is little supervision of securities intermediaries, stock exchanges, and issuers in Guatemala where the Registrar only fulfills "registry" functions. In Honduras and Nicaragua, supervision is very limited due to resource and capacity constraints, although the securities markets are also relatively under-developed. Panama faces a special challenge due to the limited resources available compared to the state of development of the market. Costa Rica appears to have been able to set up reasonable supervisory programs using a risk-based approach. Enforcement appears to be weak in the whole region, due to limitations in the legal framework (as explained above) and also because of weak enforcement culture.

Securities exchanges have been given some self-regulatory powers in most countries. In the case of Nicaragua, the new Securities Law approved in 2006 provides this role to the exchange. However, in other cases, the division of responsibilities between the regulator and the exchange is unclear, the laws are too broad, and the regulators have yet to establish more specific memoranda of understanding delineating the role of the securities exchanges. In El Salvador, the self-regulatory powers of the exchange are not well-defined in the current legal framework. Exchanges have also been weak in the exercise of their self-regulatory powers, particularly in the areas of supervision and enforcement, with Costa Rica and to a lesser extent Panama ahead of their regional peers.

III. MARKET INFRASTRUCTURE

A. Securities Exchanges

Securities exchanges exist in all seven countries. Guatemala has two exchanges, and all others have one (Table 4). In almost all the countries only the securities exchanges are authorized to operate trading systems. The majority of securities exchanges are mutualized corporations, except in El Salvador, Nicaragua and Panama, where they are demutualized. In the cases of El Salvador and Panama, the exchanges are themselves listed. All exchanges have electronic, automated systems, with the exception of Honduras. Only two countries (Costa Rica and Panama) have continuous trading systems for the secondary market. Trading systems for secondary markets are all order driven and there are no market makers. The Costa Rica exchange has a pilot project for market makers in the equity market. Only two listed companies have volunteered for the program so far, and a market maker is appointed for one, making it still early to assess its impact.

Regional securities exchanges have enjoyed some unusual privileges, in an effort to promote the development of the securities market. For example, primary public debt issuance is restricted to the securities exchange in several countries.⁶ Moreover, in some countries, it is mandatory to conduct all secondary market transactions of publicly offered securities (Costa Rica), and all repo transactions (Costa Rica, Guatemala, and Nicaragua) through the respective exchanges. At the same time, secondary market transactions in listed equity and corporate debt are not always required to be routed through the exchanges (Panama, Honduras).

⁶ In Panama, all public debt auctions must be conducted through exchange brokers. In Costa Rica, banks can participate directly in an auction, while other investors must submit their bids through brokers and pay related commissions. In El Salvador, the Ministry of Finance auctions are open not only to brokers but to other approved investors, including domestic and foreign banks, whereas central bank auctions are only open to brokers. See Shah et al (2007).

Table 4. Central America: Securities Exchanges

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
			Stock Exchange				
Number	1	1	1	2	1	1	1
Name	Bolsa Nacional de Valores	Bolsa de Valores de la Republica Dominicana	Bolsa de Valores de El Salvador, S.A. de C.V.	Bolsa de Valores Nacional y Bolsa de Productos y Mercancias	Bolsa de Valores de Centroamérica	Bolsa de Valores de Nicaragua	Bolsa de Valores de Panamá
Nature	Mutualized	Mutualized	Mutualized and listed itself	?	Mutualized	Demutualized	Demutualized and listed itself
		Trading Systems for Secondary Market Transactions					
Is it automated?	Yes	Yes	Yes	Yes	No	Yes	Yes
Continuous/discontinuous	Hybrid: continuous with market calls	Discontinuous	Discontinuous	?	?	Discontinuous	Continuous
Order driven/quote driven	Order Driven (Limit order book)	Order driven	Order driven	Order driven	Order driven	Order driven	Order driven

Source: IMF/MCM Survey

B. Clearing, Settlement, and Depository Services

Clearing and settlement processes have several weaknesses and are not uniform across the region. Almost all the countries have deficiencies in the legal framework for clearing and settlement, mainly in the recognition of the concepts of netting, novation, irrevocability and finality. All these legal issues have been addressed in a regional treaty on payments that was developed with the support of the *Consejo Monetario Centroamericano*. All countries have already signed it and it is currently in the process of legislative ratification. Settlement cycles differ across the region (Table 5).⁷ Clearance and settlement arrangements vary: Costa Rica does multilateral netting, El Salvador and Panama do netting for the cash side, while the securities side is settled on a gross basis.

Risk management practices in clearing and settlement also vary. Guatemala and Honduras have no formal risk management mechanisms. In all the other countries, there are some risk management mechanisms, with Costa Rica and Panama being more advanced. Risks from the securities leg are managed through pre-deposit (El Salvador, the Dominican Republic, and Panama) or blocking of securities after trade and lending facilities (Costa Rica). Risks from the cash leg are managed through pre-approved debt limits in a bank account (El Salvador and Panama), or a settlement fund (Costa Rica). Only in Costa Rica and El Salvador does settlement occur in central bank money. Delivery versus payment (DVP) is far from common in the region, with only Costa Rica and Panama achieving DVP.

There is a need to strengthen legal and operational aspects of depository and custodial arrangements.⁸ In general, the legal framework lacks specific provisions clarifying the role of the depository and custodial institutions, except in Costa Rica, El Salvador, and Panama, and oversight of the depository and custodial arrangements by the regulator has been weak. Dematerialization is only required in El Salvador, however in Nicaragua it is mandatory for listing and immobilization of securities (the holding of material securities within a depository institution) is required for trading in Costa Rica and Panama. In practice, most *new* issuance of private securities in the region have been dematerialized; however in some countries (Panama) investors can subsequently request the paper securities from the issuer, reversing the benefits of dematerialization.

Custodial infrastructure for corporate securities is under-developed and insufficiently centralized. Public debt accounts for the lion's share of capital markets and is often not issued in dematerialized or standardized form, with depository functions being performed by the central bank or a public sector bank. Coupled with the very small issuance of private securities, this creates a poor environment for the development and economic viability of central depository agencies. Honduras has no centralized securities depository (CSD); in the few private issuances that were dematerialized, the issuers carry their own books. In Costa Rica, the Dominican

⁷ El Salvador, Costa Rica and Panama settle at t+3 (t+1 in Costa Rica for debt), Dominican Republic and Guatemala at t+1. Nicaragua and Honduras do not have a standardized cycle; moreover in Honduras the Bolas does not provide clearing and settlement services, and brokerage houses settle their trades directly between themselves.

⁸See Brenner (2006), pp. 183–185.

Republic, El Salvador, and Panama, CSD functions are provided by a separate legal corporation, owned by the securities exchange (except Panama where it is owned separately). In Guatemala and Nicaragua, custodial services are performed by a department of the securities exchange. Despite small domestic capital markets, participants do not always agree on a single CSD. In Costa Rica, the Central bank is considering an amendment to the legal framework to allow it to provide CSD services for *corporate* securities, and in the Dominican Republic, Banco de Reserva and CEVALDOM have been competing in provision of CSD services and are currently involved in protracted negotiations about centralizing them.

Regional CSDs are under-capitalized, in need of technical improvements, and have insufficient linkages to other CSDs. Many investors, particularly foreign, regard regional CSDs as undercapitalized and in need of technological improvements. Currently, CEVALDOM (the Dominican Republic) and Latin Clear (Panama) are pursuing alliances with external partners to improve their technological infrastructure and capital base. The central securities depositories of Costa Rica, El Salvador and Panama have signed sub-custody arrangements among each other which facilitates cross country custody.

C. Rating Agencies and Price Vendors

Rating agencies have a presence throughout the region, except Nicaragua (see Table 5). None of the nationally recognized rating agencies from the United States has direct presence, but several local rating agencies have affiliation with Fitch Ratings. Rating agencies are subject to a licensing requirement and thus supervision by the securities regulator in all countries except Guatemala which has no regulator, and Panama, where the securities regulator can only register a rating agency, with no powers to supervise or sanction. In many countries, the legal framework requires rating by a local company. Given the relatively low demand for rating services in the region, it would be natural for agencies to want to operate regionally, without establishing a physical presence in each country.

The region has a major problem of illiquid securities and insufficiently developed price vendors. As discussed later in Sections VI and VII, the regional capital markets are illiquid, particularly in private securities. Illiquidity creates important problems of valuation of security portfolios, especially for mutual and pension funds and other investors who must mark to market their portfolios. Only Costa Rica and Panama—two countries with regionally more developed mutual and pension funds—have begun to address these issues. In Costa Rica, the regulators have developed common regulations for the valuation of pension funds, mutual funds and the trading portfolio of banks. Regulations do not prescribe a single methodology for the whole financial sector, merely that all members of a financial group use the same methodology to value their portfolios.⁹ In Panama, the securities exchange is working with Balmer, a Mexican price vendor, to develop a methodology for price valuation. Accurate pricing of illiquid securities is a major problem and would have to be tackled urgently, as deposit taking activities of loosely regulated

⁹ Operationally, the Costa Rican exchange (BNV) is the de facto pricing vendor. BNV has two committees, one with the participation of the industry to deal methodological issues, and the other with external advisors to deal with price disputes.

investment managers are converted into mutual funds (e.g., in El Salvador and Guatemala—see footnote 4) and as defined contribution pension plans grow. In June 2007, Proveedora Integral de Precios de Centroamericana (PIPCA), a price vendor with Mexican/Costa Rican capital, announced that it will start providing prices to investors in Costa Rica, Panama and El Salvador.

Table 5. Central America: Clearing and Settlement Systems

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
			Clearing and Settlement				
Entity in charge	BNV with participation of CEVAL.	CEVALDOM, Central de Valores Dominicana.	The BVN, using accounts at the Central Bank. Securities are liquidated at the CSD. t+3 for secondary market; t + 0 for repos	Can be done on or off-exchange. If on the exchange, the BVN is in charge	Carried out off-exchange by parties in the trade	?	Latin Clear with participation of Banco Nacional de Panama
Settlement period	t+3 for equity; t+ 1 for debt; t + 0 for repos	t+1 Gross for securities; MN for cash	Gross for securities; MN for cash	t+1 if done in the BVN	Agreed bilaterally by parties	Not deefined by regulation	t+3
System	MN		Predeposit of securities; overdraft limits in bank accounts.	?	Agreed bilaterally by parties	?	Gross for securities; MN for cash.
Risk Management	Blocking of securities after trade; settlement fund. Yes, model 2 (1.5 hours difference between cash settlement and securities settlement)	?		None	None	?	Predeposit of securities; individual bank guarantees.
Is it DVP?		No	No	No	No	No	Yes, model 2
Is in central bank money?	No	No	Yes?	No	No	No	No
			Central Security Depository				
Is dematerialization mandatory?	No, but immobilization is required for trading	No	Only for corporate debt	No	No	No	No, but immobilization required for trading
Is there a CSD?	CEVAL	CEVALDOM	CEDEVAL	The Exchange itself	There is no CSD	CENIVAL	Latin Clear
			Rating agencies				
Are there rating agencies?	Yes	Yes	Yes	Yes	Yes	No	Yes
Number of registered rating agencies	2	2	?	3	1	N.A.	5

Source: IMF/MCM Survey

IV. BUSINESS ENVIRONMENT AND THE FRAMEWORK FOR PUBLIC ISSUANCE

A. Business Environment

Basic business conditions represent a major long term challenge to improving securities markets in the region. The regional scores on basic business conditions (Table 6) are generally low.¹⁰ For 2006, out of 175 countries, El Salvador received the highest score in Central America (ranked 71), and Guatemala the lowest (ranked 118). The region scores even lower in terms of protecting investors (countries ranking from 83–156) and enforcing contracts (49–164). For development of securities markets, the quality of accounting and auditing, the adequacy of commercial and corporate law, ability to create and enforce collateral, efficiency of the bankruptcy framework, and more generally the requirements to set up corporations are particularly relevant. Our analyses below do not look at these issues in any detail, but it is consistent with the generally weak ranking of the region on these aspects by the World Bank and other studies.

Accounting standards, auditing, and transparency

Unlisted companies are not required to use international financial reporting standards (IFRS) in the majority of the countries. Guatemala, Honduras and Nicaragua use local GAAP, although in Honduras, IFRS will become mandatory in January 2008. In El Salvador, a version of IFRS as of 2003 is applicable. Thus, only in Costa Rica, the Dominican Republic, and Panama are unlisted companies required to use IFRS. However, even in these countries, implementation remains a challenge because of the lack of familiarity with IFRS.

Qualifications for auditors are generally low. Several of the top global auditing firms are present in the region. While these firms employ high international standards in conduct of their work, the *minimum* requirements for being licensed to work as an auditor are generally low, and limited to basic (not professional) academic degrees. None of the countries requires professional examinations. Continuous education is not mandatory, and efforts to implement such requirements have been rejected in some countries.¹¹ Oversight of the audit profession is very limited. Regulators in several countries do require higher standards for auditors authorized to audit regulated financial institutions and listed companies.

As a general rule, the level of transparency is low for *unlisted* companies. Companies without a public issuance are not required to make their financial statements available to the public. Thus, even for corporate businesses, public issuance involves a major change in the degree of transparency and disclosure that they are used to. In three countries (El Salvador, the Dominican Republic and Panama), companies are required to audit and file their financial statements with a

¹⁰ The World Bank's "Doing Business" indicator composite scores include such factors as procedures for starting a business, ease in hiring and firing, property registration, investor protection, tax collection, contract enforcement, cross-border trading, and business closure.

¹¹ For example, in Panama the attempt by the *Junta Tecnica de Contabilidad's* to implement continuous education requirements was ruled unconstitutional by the Supreme Court.

public entity; but they are not available to the public.¹² In Guatemala, legislation introduced in 2004 sought to impose audits on large taxpayers but the provision was suspended by the Supreme Court.

Corporate and commercial laws, collateral, and bankruptcy

Requirements for registration of a corporation are not a major problem. While there is room for streamlining, this does not appear to be a critical constraint vis-à-vis other issues relating to basic business conditions. In particular, in the cases of Costa Rica and the Dominican Republic the average time required for registration is far longer than in the rest of the region. Panama and El Salvador have made significant progress in facilitating business formation, and Panama now has the most efficient process in Latin America. Honduras has also made important progress due to the outsourcing of the Corporate Registry to the Chamber of Commerce.

Many countries face problems with the *constitution* of collateral. The main problem relates to delay in the registration process, and the security of registration, which were cited as important challenges in the Dominican Republic, Nicaragua, and Honduras. Also, in some countries, the lack of registration of pledges on movable assets is a significant factor which limits its reliability and acceptance by creditors.

The majority of the countries also face problems with the *execution* of collateral. In most countries, execution requires judicial proceedings that are lengthy and somewhat unpredictable due to overburdened courts and lack of specialization of judges. Nevertheless, some attempts to streamline execution of collateral have been made. Nicaragua and Dominican Republic have created special parallel judicial procedures for banks, although inadequate independence of the judiciary is perceived to be a major problem in Nicaragua. In Honduras, a recent amendment to the Notary Law allows execution of collateral directly by a notary through a much abbreviated process. However, these provisions have not yet been adequately tested. In some countries (Costa Rica, and Honduras), market participants have bypassed judiciary proceedings through the use of “security trusts” as an alternative means of enforcement of collateral.

¹² All companies in El Salvador, and companies above a threshold in Dominican Republic and Panama.

Table 6. Central America: Indicators of Ease of Doing Business, 2006

Country		Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama	CA Average	LA Region	OECD
Ease of Doing Business Rank		105	117	71	118	111	67	81	95.7		
Starting a Business	Rank	99	119	123	130	138	62	26	99.6		
	Procedures (number)	11	10	10	13	13	6	7	10.0	10.2	6.2
	Time (days)	77	73	26	30	44	39	19	44.0	73.3	16.6
	Cost (% of income per capita)	23.5	30.2	75.6	52.1	60.6	131.6	23.9	56.8	48.1	5.3
	Min. capital (% of income per capita)	0	1.1	119.7	26.4	28.6	0	0	25.1	18.1	36.1
Getting Credit	Rank	33	33	33	48	21	48	13	32.7		
	Legal Rights Index	4	4	4	4	6	4	6	4.6	4.5	6.3
	Credit Information Index	6	6	6	5	5	5	6	5.6	3.4	5.0
	Public registry coverage (% adults)	2.5	11.9	30.5	16.1	8.3	12.5	0	11.7	7.0	8.4
	Private bureau coverage (% adults)	39.2	57.1	79.6	9.2	18.7	3.4	59.8	38.1	27.9	60.8
Protecting Investors	Rank	156	135	99	135	151	83	99	122.6		
	Disclosure Index	2	5	6	3	1	4	3	3.4	4.3	6.3
	Director Liability Index	5	0	2	3	5	5	4	3.4	5.1	5.0
	Shareholder Suits Index	2	7	6	6	4	6	7	5.4	5.8	6.6
	Investor Protection Index	3	4	4.7	4	3.3	5	4.7	4.1	5.1	6.0
Paying Taxes	Rank	160	146	85	122	152	153	164	140.3		
	Payments (number)	41	87	66	50	48	64	59	59.3	41.3	15.3
	Time (hours)	402	178	224	294	424	240	560	331.7	430.5	202.9
	Total tax rate (% profit)	83	67.9	27.4	40.9	51.4	66.4	52.4	55.6	49.1	47.8
Enforcing Contracts	Rank	114	108	116	149	124	49	164	117.7		
	Procedures (number)	34	29	41	36	36	20	45	34.4	39.3	22.2
	Time (months)	51	38	52	122	40	41	57	57.3	53.5	29.3
	Cost (% of debt)	18.7	35	15	26.5	30.4	21.8	50	28.2	23.4	11.2
Closing a Business	Rank	118	142	79	83	102	66	71	94.4		
	Time (years)	3.5	3.5	4	3	3.8	2.2	2.5	3.2	2.6	1.4
	Cost (% of estate)	14.5	38	9	14.5	8	14.5	18	16.6	13.6	7.1
	Recovery rate (cents on the dollar)	17.6	7.4	29.2	28.3	23	34.3	32.3	24.6	25.7	74.0
Economy Characteristics	GNI per capita (US\$)	4590	2370	2450	2400	1190	910	4630	2648.6		
	Population	4,327,228	8,894,907	6,880,951	12,599,059	7,204,723	5,486,685	3,231,502			

Indices range from 0 to 10, with higher scores indicating more favorable business conditions. Rankings compare 175 economies during 2006.

Source: World Bank, Doingbusiness.org.

Throughout the region, bankruptcy laws are outdated and need to be modernized. The most common problems are excessive protection of debtors, excessive judicial intervention, and a lack of expertise of bankruptcy judges in economic and financial matters, all of which result in lengthy and somewhat unpredictable proceedings. Most of the countries also lack frameworks for effective out-of-court settlements, resulting in considerable delays in enforcing contracts or closing business. Some countries (Costa Rica and the Dominican Republic) have made amendments to bankruptcy laws to permit reorganization proceedings that allow illiquid but potentially viable companies to remain operating (similar to the U.S. Chapter 11). However, these reforms have shortcomings that have limited their use in practice.

Taxation

Tax treatment of securities income also generally deters investment in private securities. This is a complex subject and not studied comprehensively in this study. However, the available information suggests that regional tax systems are generally not neutral, by and large favoring investment in public debt over private securities, and bank deposits over debt and equity securities (Table 7). Typically, interest and capital gains from private debt and equity securities are taxed at higher rates than corresponding public debt. Dividends are taxed in addition to corporate income tax, and private securities are subject to certain transfer taxes and value-added tax which do not apply to public securities. Costa Rica, in particular, has a very complex framework, with different tax treatments depending on the nature of the issuer, the currency and the investor. El Salvador seems to be the most neutral, with the same tax treatment across the board, with the Dominican Republic a close second.

B. The Regulatory Framework for Public Issuance

Securities regulators have addressed some of the weaknesses of the business framework by establishing stronger accounting and auditing requirements for public issuance. The most important examples relate to the accounting and auditing framework and the level of financial transparency required. Listed companies in all countries except Guatemala are required to use either IFRS (in Costa Rica, the Dominican Republic, El Salvador, and Honduras) or US GAAP (in Nicaragua and Panama). In addition, listed companies in all countries are required to audit and publish their financial statements. The majority of the regulators have also tried to impose additional professional and independence requirements on external auditors authorized to audit listed firms, as well as a registry of such auditors.¹³ Securities regulators have imposed non-financial disclosure requirements for equity and corporate debt issuers; however the framework is weak for equity issuers, particularly in the area of corporate governance.

¹³ However, in some countries (Panama and Costa Rica) the use of regulatory powers over external auditors has been challenged before the courts.

Table 7. Central America: Taxation of Income from Securities

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Corporations							
Income tax	Special regime for 30% SME	29% S	25%	General regime 5% (gross) 31% Optional regime (net)	Temporary SS 25% tax 5%	30%	30%
Government debt							
Capital Gains	E	29% S	10% Individuals trading at E Stock Exchange	10% General regime 31% Optional regime	10% WH/ND	E	E
Interest	NS dollars 8% colones WH/D	E	25% S 10% WH for corporations Individuals trading at E Stock Exchange	10% WH/D except for Fis Net income for 31% supervised Fis		E	E
Private debt securities							
Interest Listed	8% WH/D	E	25% S 10% WH for corporations Individuals trading at E Stock Exchange	10% WH/D	10% WH/ND	10% WH/ND	E
Not listed	15% WH/D	10%		10% WH/D	10% WH/ND	10% WH/ND	5% if CNV registered S WH/ND
Special cases	8% colones WH/N NS dollars NS at state owned banks NS BHV colones or dollars NS BPDC colones	E		All supervised Fis have no WH but pay 31% net income tax	Corporate 25% income tax for		
Capital Gains Listed	S	29% S	Individuals trading at 10% Stock Exchange	10% General regime 31% Optional regime	S	E	E
Not Listed	S	29% S		10% General regime 31% Optional regime	S	NS	5% of transaction amt 10% of capital gains
Other taxes Listed	N	3.00% Transfer taxes 0.15% Check taxes 1.00% Fixed asset tax		VAT exempt		N	
Not Listed	N	3.00% Transfer taxes 0.15% Check taxes 1.00% Fixed asset tax		12% VAT		N	0.01% Stamp duty 1.00% Special Fund

Table 7: Central America: Taxation of Income from Securities (concluded)

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Equity securities							
Dividends							
Listed	5.00%	29.00% in cash E in stock	25% S for corporations if share's issuer E declared them and paid tax	E	S	N	E
Not listed	15.00%	29.00% in cash E in stock	25% S for corporations if share's issuer E declared them and paid tax	E	S	E	10% WH/ND for dividends from non-taxable E sources
Capital Gains							
Listed	S	29.00% S	10% Individuals trading at E Stock Exchange	10% General regime 31% Optional regime	S	N	E
Not listed	S	S	10%	10% General regime 31% Optional regime	S	NS	5% of transaction amt 10% of capital gains
Other Taxes							
Listed	N	3.00% Transfer taxes 0.15% Check taxes 1.00% Fixed asset tax		3% Stamp duty	N	N	E
Not listed	N			3% Stamp duty	N	N	0.01% Stamp duty 1.00% Special Fund
Bank Deposits							
Interest	NS	29% S	25% S	10% WH / D except for Fis	ISR for deposits over L50K	10% WH/ND, if over \$5K	E
Other taxes	N	E	10% WH for corporations E for individuals	N	N	N	
Mutual funds							
	Interest on securities that already paid or were exempted from 0% tax	E Interest	25% S	N	10% WH/D	N	E if listed
	Other interest for 5% securities that did not pay tax	29% Dividends	10% WH for corporations				E for dividends if portfolio is listed
	5% Capital gains WH/ND		E Individuals				
Pension funds							
Tax treatment of the PF			E	N	D for contributions	N	Mandatory public pension funds contributions are not deductible as expenses but pensions are tax free.
	E Capital Gains	29% Capital Gains			NS for capital gains		
Other incentives	D for voluntary contributions		Contributions are not considered from income tax	Banks can manage funds and contributions are deductible from income tax			Contributions to private deductible from income tax
Source:	IMF/MCM survey						
Notes:	S Subject to income tax NS Not subject to tax	E Exempt N Non-existent	D Deductible from income tax ND Non deductible from income tax	WH Withholding tax			

Requirements for equity issuance

There is no minimum issuance or minimum float requirement in most of Central America. A minimum issuance amount of C100 million (about \$2 million) is specified in Costa Rica, the only country to require a minimum issuance amount for equity. None of the seven countries require a minimum float.

Disclosure requirements for equity issuers are weak in most countries. The most common problems relate to: (i) timely disclosure to the public of insider and/or substantial holdings; (ii) timely disclosure to the public of material events;¹⁴ and (iii) the minimum requirements for the prospectus, which generally fall short of international best practices (Tables 8 and 9).

In addition, corporate governance and protection of minority rights is weak throughout the region. All the countries in the region have a basic framework for corporate governance for unlisted companies in their Commercial Codes, and this framework does not differ significantly from other countries with Napoleonic tradition. However, for companies with publicly issued securities, this basic framework should be complemented with other provisions that afford an appropriate level of protection to minority shareholders. This additional framework is almost absent in the region (Table 10). Most countries lack adequate public disclosure of insider and/or substantial holdings. Only in four countries (Costa Rica, the Dominican Republic, Honduras, and Panama), does acquisition of control in a listed company (under certain circumstances) require a mandatory tender offer to all shareholders. Only two countries (Honduras and Panama) have developed codes of corporate governance, but even in those countries the codes require further strengthening in issues such as independent directors, qualifications of directors and use of supporting committees by the board. In Costa Rica, the BNV has issued a Corporate Governance Code for voluntary adoption. In addition, the banking, securities and pension regulators are developing a corporate governance code for supervised entities.

Requirements for corporate debt issuance

Disclosure requirements for corporate debt issuers are more complete than those for equity. In the majority of the countries disclosure requirements are reasonable; the main exception is Guatemala where private debt issuers are not required to disclose material events, nor to update the information in the prospectus. Perhaps the main area of weakness is the timeliness of disclosure of material events (Tables 11 and 12).

¹⁴ No disclosure of material events is required in Guatemala, and the deadlines for disclosure are loose or not defined in Dominican Republic and El Salvador.

Table 8. Central America: Equity Issuers Registration Requirements

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
1. System							
Do issuers have to carry out separate registration and listing processes?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
2. Registration requirements							
a) Is there a minimum issuance amount?	C100 million	No	No	No	No	No	No
b) Minimum free float requirement?	No	No	No	No	No	No	No
c) Is dematerialization mandatory?	No, but immobilization required for trading	No	No	No	No	No	No, but immobilization required for trading
3. Financial Statements							
a) Mandatory filing?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b) Mandatory auditing?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
c) Accounting principles?	IFRS	IFRS	IFRS as of Oct-03	Local GAAP	Local GAAP IFRS in 2008 3 fiscal years (or less if company is new)	US GAAP?	IFRS or US GAAP
d) Numer of audited periods that have to be presented	?	3 fiscal years	?	?		3 fiscal years	Last fiscal year
4. Prospectus							
a) Mandatory filing?	Yes	Yes	Yes	Yes 1/	Yes	Yes	Yes
b) Minimum content							
Issuance	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Issuing company	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Risk factors	Yes	Yes	No	Yes	Yes	Yes	Yes
Financial results (Management report)	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Directors, managerial staff, employees	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Insider/substantial holdings, related-party operations.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
5. Legal and administrative information							
a) Company by-laws	Main info in prospectus. Rest available at SUGEVAL	Yes	Yes	No	Yes	Yes	Yes if company provides
b) Issuance agreement	Yes	Yes	Yes	No	Yes	Yes	Yes

Source: IMF/MCM survey

1/ If the offering is carried out off the exchange.

Table 9. Central America: Equity Issuers On-Going Disclosure Requirements

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
1. Quarterly Financial Statements							
a) Is filing required?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b) Deadline	20 days if issuer does not consolidate 30 business days if issue consolidates with local companies 40 business days if issuer consolidates with foreign companies	Not defined	30 days after end of quarter	3 days after close of quarter	20 calendar days after end of quarter	1 month	2 months after end of quarter
2. Annual financial statements							
a) Is filing required?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b) Deadline	40 days if issuer does not consolidate or consolidates with local companies 45 days if issuer consolidates with foreign companies	Not defined	35 days after close of fiscal year	?	April 30	3 months	3 months after end of fiscal year
c) Do they have to be audited?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
3. Material events							
a) Mandatory disclosure	Yes	Yes	Yes	No	Yes	Yes	Yes
b) Deadline	No later than 1 business day	Not defined	8 days	N.A.	15:00 hours of following day	Immediate	1 business day after it happened
4. Insider holdings							
a) Must insider participation be disclosed?	Yes	No	Yes	No	No	No	Yes
b) Is there a threshold?	No	N.A.	10%	N.A.	N.A.	N.A.	No
c) Filing deadline	5 business days	N.A.	8 days	N.A.	N.A.	N.A.	In the prospectus
d) Is this information public?	Yes, at the SUGEVAL	N.A.	Yes in the Registry	N.A.	N.A.	N.A.	In the prospectus
5. Substantial holdings							
a) Must substantial holdings be disclosed?	Yes	Yes	Yes	No	Yes	Yes	Yes
b) Percentage share that must be disclosed?	10%	Not defined	10%	N.A.	10%	5%	25%
c) Filing deadline	5 business days	Not defined	8 days	N.A.	?	1 month	No. Must be included in the prospectus
d) Is this information public?	Yes, at the SUGEVAL	?	Yes in the registry	N.A.	Yes	Yes	Yes. In the prospectus
6. Prospectus							
a) Must prospectus be updated frequently?	Yes	Yes	No	No	Yes	Yes	Yes
Frequency	Annually	Annually	N.A.	N.A.	Any time the conditions of the offering have changed	Annually	Annually. 30 days after general report is submitted

Source: ICM/MCM survey

Table 10. Central America: Corporate Governance

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
1. Is there a code of corporate governance? 1/	Yes	No	No	No	Yes	No	Yes
2. If yes: is it mandatory, voluntary or comply or explain	Voluntary	N.A.	N.A.	N.A.	Mandatory	N.A.	Voluntary
3. If yes, are companies required to submit a compliance report	N.A.	N.A.	N.A.	N.A.	No	N.A.	Yes, annually
4. If yes, are there obligations on:							
a) Disclosure of information							
Establishment of an investor relations office	N.A.	N.A.	N.A.	N.A.	No	N.A.	No
Establishment of a Web site	N.A.	N.A.	N.A.	N.A.	No	N.A.	No
b) Voting rights	N.A.	N.A.	N.A.	N.A.		N.A.	
Proxy	N.A.	N.A.	N.A.	N.A.	Yes	N.A.	No
Cumulative voting	N.A.	N.A.	N.A.	N.A.	No	N.A.	No
c) Board members							
Minimum number of non executive members	N.A.	N.A.	N.A.	N.A.	No	N.A.	No
Minimum numbers of independent members	N.A.	N.A.	N.A.	N.A.	Yes	N.A.	1 for every 5 members recommended
Fit and proper requirements	N.A.	N.A.	N.A.	N.A.	Yes	N.A.	No
d) Auditing committee							
Fit and proper requirements	N.A.	N.A.	N.A.	N.A.	No	N.A.	Basic
Minimum number of independent members	N.A.	N.A.	N.A.	N.A.	No	N.A.	30% Recommended
e) Selection committee							
Minimum number of independent members	N.A.	N.A.	N.A.	N.A.	No	N.A.	No
f) Remuneration committee							
Minimum number of independent members	N.A.	N.A.	N.A.	N.A.	No	N.A.	No
Public disclosure of salaries of board and management	N.A.	N.A.	N.A.	N.A.	No	N.A.	?
g) Risk management committee	N.A.	N.A.	N.A.	N.A.	Yes	N.A.	Yes
Fit and proper requirements	N.A.	N.A.	N.A.	N.A.	No	N.A.	No
Minimum number of independent members	N.A.	N.A.	N.A.	N.A.	No	N.A.	30% recommended
5. Tender offer							
a) Is a tender offer mandatory?	Yes	Yes	No	No	Yes	No	Yes
b) If yes, what is the threshold?	25%	Not defined	N.A.	N.A.	25%	N.A.	20%
c) Could it be partial?	Yes	Not defined	N.A.	N.A.	Yes	N.A.	Yes
Commercial Code							
1. Does the one ordinary share one vote rule applies?	Yes	Yes	Yes	Yes	Yes	No?	No
2. Are non voting shares allowed?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
3. Is cumulative voting allowed?	Yes	Yes	No	Yes	No	Yes	Yes
4. Aside from the prescribed instances of ordinary and extraordinary meetings, can shareholders call meetings?	Yes	?	Yes	Yes	Yes	Yes	Yes
5. Minimum percentage to call a shareholding meeting?	25%	?	5% A single shareholder in special circumstance	25%	25% A single shareholder in special circumstances	?	Up to By Laws

Source: IMF/MCM survey

1/ For Costa Rica, code was recently approved and authorities have not provided information on its content.

Table 11. Central America: Debt Issuers Registration Requirements

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
1. System							
a) Do issuers have to carry out separate registration and listing processes?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b) Is there an obligation to list debt issuances?	No 1/	No	Yes	Yes?	Yes?	Yes	No
c) Is there an obligation to carry out secondary market transactions in the stock exchange?	Yes	No?	Yes	Yes?	Yes?	Yes	No
d) If no, is there an obligation to report all OTC transactions?	N.A	No. Mandatory as of 2008	N.A.	N.A.	N.A.	N.A.	No
2. Registration requirements							
a) Is there a minimum issuance amount?	C 100 million	No	No	No	No	No	No
c) Is standardization mandatory?	Yes	Yes	No	No	Yes?	Yes	Yes
d) Is dematerialized mandatory?	No	No	Yes	No	No	No	No?
e) Is a legal representative of debt holders required?	No	Yes	No	Yes	Yes	No	No
3. Risk rating							
a) Is rating mandatory?	Yes	Yes	Yes	No	Yes	Yes	No
b) If yes, number of required ratings	1	2	1 (2 for pension funds)	N.A.	1	1	
4. Financial statements							
a) Mandatory filing?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b) Mandatory auditing?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
c) What are the accounting Principles?	IFRS	IFRS	IFRS	Local GAAP	IFRS	US GAAP?	IFRS or US GAAP
d) Number of audited periods that have to be presented	?	3 fiscal years	Last fiscal year	?	3 fiscal years	3 fiscal years	?
5. Prospectus							
a) Mandatory filing?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b) Minimum content:							
Issuance	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Issuance guarantees	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Issuing company	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Risk factors	Yes	Yes	No	Yes	Yes	Yes	Yes
Financial results (Management report).	Yes	Yes	Yes	Yes	Yes	Yes	Yes
6. Legal and administrative information							
Is there mandatory filing of the following documents:							
a) Company by-laws	Yes	Yes	Yes	Yes	Yes	Yes	No?
b) Issuance agreements	Yes	Yes	Yes	Yes	Yes	Yes	Yes
c) Guarantees	Yes	Yes	Yes	Yes	Yes	Yes	Yes

1/ But all secondary market transactions have to be carried out in the stock exchange

Source: IMF/MCM survey

Table 12. Central America: Debt Issuers On-Going Disclosure Requirements

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
1. Rating							
Mandatory update?	Yes	Yes	Yes	N.A.	Yes	Yes	N.A.
Frequency	Biannually	Not defined	Every 3 months	N.A.	Every 3 months	Every 3 months	N.A.
2. Quarterly Financial Statements							
a) Is filing required?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b) Deadline	20 days if issuer does not consolidate 30 business days if issuer consolidates with local companies 40 business days if issuer consolidates with foreign companies	Not defined	30 days after end of trimester	Not defined	20 calendar days after end of trimester	1 month	2 month after end of trimester
3. Annual financial statements							
a) Is filing required?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b) Deadline	40 days if issuer does not consolidate or consolidates with local companies 50 days if issuer consolidates with foreign companies	Not defined	45 days after end of fiscal year	Not defined	April 30	3 months	3 months after end of fiscal year
c) Mandatory auditing?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
4. Material events							
a) Mandatory disclosure?	Yes	Yes	Yes	No	Yes	Yes	Yes
b) Deadline	Immediate but not later than 1 business day	Not defined	8 days	N.A.	15:00 hours of following day	Immediate	1 business day after it happened
5. Prospectus							
a) Mandatory update?	Yes	Yes	Only if subscription period was extended	No	Yes	Yes	Yes
b) Frequency	Annually	Annually	N.A.	N.A.	Any time offer conditions have changed	Annually	Annually. 30 days after general report is submitted

Source: IMF/MCM survey

Most countries require a rating for each issue. As in many other developing countries, the legal framework of all countries (except Panama) requires mandatory rating of corporate debt issuances (see Tables 10 and 11). Given the shortcomings in the availability and reliability of financial information, as well as in other research and analysis services, such measure is reasonable. However, in two countries (Honduras and the Dominican Republic) two ratings are required in certain circumstances, which could be deemed excessive.

Authorization process

Authorization of securities issuance needs to be streamlined throughout the region. There are several problems. The regulators frequently do not provide comments all at once, drawing out the approval process. The regulatory reviews tend to be more formal and less focused on material events that affect the value of securities. Market participants complain of inconsistent responses across time and issues. The coordination of authorization and listing between the regulator and the exchanges¹⁵ also needs improvement in several countries. There are of course also problems of inadequate filing of documents by potential issuers. As a result of these problems, the authorization process ends up being protracted (often six months or more), costly and uncertain, creating incentives to favor bank loans rather than securities issuance.

Some regulators have taken some measures to alleviate these problems. Useful approaches include establishing deadlines for all comments to the issuers (in Costa Rica), for the authorization process (in Costa Rica¹⁶ and Panama), and establishing a fast track approval process (basically a “shelf” registration regime) for certain types of bond issuances (e.g., in Costa Rica, and in Panama for commercial paper).

In addition, review of compliance with periodic disclosure has been limited. In most countries, supervision is limited to verifying the timely submission of information, but the actual content is not rigorously examined. Costa Rica has made more advances in this area. In addition, in a number of countries, market supervision and enforcement have been weak due in part to weaknesses in the legal framework, (inadequate description of offenses and/or adequate sanctions). Thus, the public perception in some of these countries is that there is insider trading and market manipulation, with insufficient action taken by the regulator.

V. INSTITUTIONAL INVESTORS

As with many small and emerging countries, and despite recent rapid growth, the regional institutional investor base remains poorly developed and as yet does not offer a significant source of demand for securities.¹⁷

¹⁵ In. El Salvador, the law requires presentation of the issuance documents first to the exchange by a broker, and then by the exchange to the securities regulator.

¹⁶ Securities regulators in Costa Rica are planning to increase the staff dealing with the authorization process substantially in 2008 and also set up an advisory committee to revise current processes.

¹⁷ Although, as discussed later in Sections VII and VIII, supply of securities is probably a more binding problem.

Pension funds are not well-developed in most Central American countries and their investment regime is constrained. Guatemala, Honduras, Nicaragua, and Panama still have significant gaps in their legal framework for private pension funds (Table 13). Guatemala and Nicaragua do not report any significant activity by pension funds. While Panama does have public sector pension funds, defined contribution private pension plans exist only in Costa Rica, the Dominican Republic, El Salvador, and Honduras. Moreover, all countries have fairly tight limitations on investment, particularly in private securities, by pension funds. Equity investment is not allowed to exceed 10 percent of total portfolio in any country, and investment in corporate debt and ABS are also tightly restricted.

Table 13. Central America: Regulation of Mutual and Pension Funds

	Costa Rica	Dominican Republic	El Salvador Mutual Funds	Guatemala	Honduras	Nicaragua	Panama
Is there a legal framework?	Yes	Yes	No 1/	No 2/	Yes	Yes	Yes
Has the regulator issued complementary regulations?	Yes	Yes?	N.A.	N.A.	Yes	No	Yes
Are the funds allowed to invest in:	According to investment policy in prospectus						According to investment policy in prospectus
a) Public debt	Yes	Yes	N.A.	N.A.	Yes	N.A.	Yes
b) Stocks	Yes	Yes	N.A.	N.A.	Yes	N.A.	Yes
c) Corporate debt	Yes	Yes	N.A.	N.A.	Yes	N.A.	Yes
d) Securitization issuances	Yes	Yes	N.A.	N.A.	Yes	N.A.	Yes
e) Foreign securities	Yes	Yes	N.A.	N.A.	Yes	N.A.	Yes
			Pension funds				
Is there a legal framework?	Yes	Yes	Yes	No	Only for public pension funds	Yes, but not implemented	Yes
Has regulator issued complementary regulations?	Yes	Yes	Yes	N.A.	Yes	N.A.	?
Are the funds allowed to invest in:							
a) Local Public debt	Max 50%	No	Max 50%	N.A.	Max 50%	N.A.	?
b) Stocks	Max 10%	Yes	Max 5%	N.A.	Max 10%	N.A.	?
c) Corporate debt	Yes	Yes	15-40%	N.A.	Max 10%	N.A.	?
d) Securitization issuances	Yes	Yes	Max 20%	N.A.	Max 30% with rating	N.A.	?
e) Foreign securities	Max 25%	No	Max 20% but must be done through the local stock exchange	N.A.	No	N.A.	?

Source: IMF/MCM survey

1/ Brokerage houses administer 'carteras de inversión' which are poorly-regulated quasi mutual funds.

2/ The legal framework includes 'sociedades de inversión' which are poorly-regulated quasi mutual funds.

Aggregate assets of the regional pension funds amounted only to about \$7.4 billion at end-2006, or about 5.4 percent of regional GDP. Total assets of public and private pension funds (Table 14) are significant only in El Salvador and Honduras (about 19 percent of GDP), and in Costa Rica (7 percent). While information available on asset composition is sketchy, it appears that only about 5 percent of the total assets were invested in stocks, and another 8 percent or so were invested in local corporate debt, with the public securities and foreign securities accounting for the lion's share.

Table 14. Central America: Pension Funds

	Number of authorized pension funds					
	2001	2002	2003	2004	2005	2006
Costa Rica	32	27	26	24	24	24
Dominican Republic	0	0	9	8	7	7
El Salvador	3	2	2	2	2	2
Honduras	5	5	5	5	6	6
Panama	2	2	2	2	2	2
Total	42	36	44	41	41	41

	Assets under Management (US\$ million)					
	2001	2002	2003	2004	2005	2006
Costa Rica	559	772	1,034	830	1,112	1,502
Dominican Republic	-	-	34	184	368	643
El Salvador	790	1,099	1,599	2,224	2,949	3,495
Honduras	-	-	-	-	-	1,727
Panama	22	28	35	52	72	73
Total	1,371	1,899	2,702	3,290	4,501	7,440

	Assets under Management (percent of GDP)					
	2001	2002	2003	2004	2005	2006
Costa Rica	3.4	4.6	5.9	4.5	5.6	7.0
Dominican Republic	0.0	0.0	0.2	1.0	1.3	2.0
El Salvador	5.7	7.7	10.6	14.1	17.4	19.1
Honduras	0.0	0.0	0.0	0.0	0.0	19.2
Panama	0.2	0.2	0.3	0.4	0.5	0.4
Total	1.4	1.9	2.8	3.1	3.6	5.4

Source: IMF/MCM survey

Mutual funds have an even smaller presence in the region. They exist only in two countries, Costa Rica and Panama.¹⁸ El Salvador and Guatemala have yet to develop an adequate legal framework, while Nicaragua has yet to issue detailed regulation for mutual funds (see Table 13). The mutual funds industry in the region needs to overcome a bad image problem, given its origination in informal and poorly regulated investment pools, involving considerable

¹⁸ El Salvador and Guatemala have loosely regulated quasi-mutual fund-like products (*carteras de inversion* in El Salvador and *sociedades de inversion* in Guatemala) under which brokerage houses, some associated with banks, accept deposits into special accounts that seek to obtain a higher return by investing mostly in public securities.. Several institutions in Costa Rica suffered significant problems in 2002, after which the regulation of these products was substantially improved to conform with international norms.

maturity transformation, whose risks are not always adequately controlled, regulated, or understood by the depositors. Finally, there are problems in authorization requirements and regulations which are deemed burdensome by market participants, e.g., in Costa Rica.

The mutual fund industry appears to face several efficiency challenges. There are 163 mutual funds with aggregate assets of only to about \$2.1 billion (Table 15). On average, a mutual fund only manages about \$12 million, which is very low, even allowing for multiple funds managed by the same house. Second, the industry suffers from a lack of sufficient diversity of regional private sector assets that would enable local mutual funds to add value in a special niche. The Panamanian funds appear to invest bulk of their assets in local corporate bonds, while in Costa Rica, the funds appear not to invest in equity, 27 percent in corporate bonds, and the rest in sovereign and foreign securities. This makes the Costa Rican funds susceptible to foreign competition.

The penetration rates for the insurance industry are very low, especially in life and annuity segments. An enabling legal framework exists in most countries and insurance companies face little or no restrictions on their investment plans. However, the insurance industry is currently inconsequential for the development of markets given the low level of assets under management (0-5 percent of GDP), which reflects the low income levels as well as a significant transfer of their exposure to foreign reinsurers. The business also appears to be rather fragmented, with 105 companies operating at the end of 2006.

VI. EQUITY MARKETS

A. Current Status

Several Central American equity markets are severely underdeveloped. There are no equity markets in four out of the seven countries (Guatemala, Honduras, Nicaragua, and the Dominican Republic), and markets are small and shrinking in the other three (El Salvador, Costa Rica, and Panama (Table 16)). Market capitalization in El Salvador and Panama, at around 40 percent of GDP, compares reasonably well with other small developing countries, but is quite low at 8 percent of GDP in Costa Rica. Market concentration is very high, with the top five companies making up more than half of capitalization in El Salvador and more than two-thirds in Costa Rica and Panama. Secondary markets trading is almost nonexistent, with only 1 and 3 percent of market capitalization changing hands per year.

Table 15. Central America: Mutual Funds

Total number of Mutual Funds authorized for PO						
	2001	2002	2003	2004	2005	2006
Costa Rica	129	131	144	135	131	128
Panama	13	14	14	16	21	23
Total	142	145	158	151	152	163

Number of funds authorized for equity investment						
	2001	2002	2003	2004	2005	2006
Costa Rica	3	3	3	3	2	2
Panama					8	10
Total	3	3	3	3	10	12

Number of funds authorized for corporate debt investment						
	2001	2002	2003	2004	2005	2006
Costa Rica	50	59	73	47	62	57
Panama					13	13
Total	50	59	73	47	75	70

Total Assets under Management (US\$ million)						
	2001	2002	2003	2004	2005	2006
Costa Rica	1618	1787	2813	1346	1254	1569
Panama	270	304	282	494	524	488
Total	1888	2091	3095	1840	1778	2057

Percent of net assets invested in local equities						
	2001	2002	2003	2004	2005	2006
Costa Rica	1	0	0	0	0	0
Panama	0	0	0	0	2	3
Total	0	0	0	0	1	1

Percent of net assets invested in local corporate debt						
	2001	2002	2003	2004	2005	2006
Costa Rica	4	4	5	3	2	5
Panama	0	0	0	0	98	97
Total	3	4	4	2	31	27

Total Assets under Management (percent of GDP)						
	2001	2002	2003	2004	2005	2006
Costa Rica	9.9	10.6	16.1	7.2	6.3	7.3
Panama	2.3	2.5	2.2	3.5	3.4	2.9
Total	2.0	2.1	3.2	1.7	1.4	1.5

Source: IMF/MCM survey

Table 16. Central America: Equity Market Capitalization and Turnover

Equity Market capitalization (US\$ millions)						
	2001	2002	2003	2004	2005	2006
Costa Rica	2,466	2,141	1,696	1,406	1,417	1,841
El Salvador	0	1,937	1,972	3,500	4,849	7,716
Panama	2,602	2,950	3,075	4,047	5,732	6,819
Total	5,068	7,028	6,743	8,953	11,998	16,376
of the 5 top companies						
	2001	2002	2003	2004	2005	2006
Costa Rica	2,021	1,810	1,436	1,189	1,228	1,527
El Salvador	0	1,377	1,386	2,220	2,891	4,460
Panama	1,664	1,975	2,298	3,139	4,314	5,424
Total	3,685	5,162	5,120	6,548	8,433	11,411
Equity Market capitalization (percent of GDP)						
	2001	2002	2003	2004	2005	2006
Costa Rica	15.0	12.7	9.7	7.6	7.1	8.6
El Salvador	0.0	13.5	13.1	22.1	28.6	42.1
Panama	22.0	24.0	23.8	28.5	37.0	39.8
Total	5.3	7.1	6.9	8.4	9.5	11.9
Market capitalization of the 5 top companies (percent of GDP)						
	2001	2002	2003	2004	2005	2006
Costa Rica	12.3	10.7	8.2	6.4	6.2	7.1
El Salvador	0.0	9.6	9.2	14.0	17.0	24.3
Panama	14.1	16.1	17.8	22.1	27.9	31.7
Total	3.9	5.2	5.2	6.2	6.7	8.3
Trading volume (in US \$ million)						
	2001	2002	2003	2004	2005	2006
Costa Rica	86	81	33	45	28	25
El Salvador	23	24	10	503	80	197
Panama	45	59	45	54	75	149
Total	154	164	88	602	183	370
Turnover ratio (percent) 1/						
	2001	2002	2003	2004	2005	2006
Costa Rica	7.0	3.5	1.7	2.9	2.0	1.5
El Salvador		2.5	0.5	18.4	1.9	3.1
Panama	1.7	2.1	1.5	1.5	1.5	2.4
Total	3.1	2.7	1.3	7.7	1.7	2.6

Source: IMF/MCM survey

1/ Trading volume divided by market capitalization

The universe of listed stocks is extremely small and shrinking. At the end of 2006, there were 88 equity issues listed in Central America region (Table 17). There are 18 companies listed in Costa Rica (compared to 25 in 2001), 24 in Panama (28 in 2001) and 43 (40 in 2002) in El Salvador (see Table 16). The relatively larger number of listed firms in El Salvador is the result of public sector privatizations implemented through the stock market and the fact that banks, insurance companies, pension funds and other financial institutions are required by law to list on the stock exchange. While these measures have boosted listings and market capitalization, very few of these stocks are traded in the secondary market. More worrisome is the fact that over time, equity listings have been shrinking due to companies delisting following foreign purchases of local companies and to avoid information disclosure, with fewer initial public offerings (IPO) than delistings. Finally, while the volume of new equity issuance is variable, it seems to have fallen considerably from the highs (\$270 million in 2002) to \$95 million in 2006.

Table 17. Central America: Equity Issuance and Delisting

	Number of listed companies					
	2001	2002	2003	2004	2005	2006
Costa Rica	25	22	20	22	20	18
El Salvador	0	40	39	39	45	43
Guatemala	0	3	3	3	3	3
Panama	28	26	25	26	26	24
Total	53	91	87	90	94	88

	Number of IPOs					
	2001	2002	2003	2004	2005	2006
Costa Rica	5	1	3	2	0	0
El Salvador	0	0	0	0	0	0
Panama	3	3	0	3	1	4
Total	8	4	3	5	1	4

	Value of IPOs:					
	2001	2002	2003	2004	2005	2006
Costa Rica	61	200	46	13	0	0
El Salvador	0	0	0	0	0	0
Panama	75	70	0	190	25	95
Total	135.5	270.3	45.9	202.6	25	95

	Number of companies that requested delisting during year					
	2001	2002	2003	2004	2005	2006
Costa Rica	3	4	5	0	2	2
El Salvador	3	0	0	6	2	1
Panama	1	4	2	2	0	2
Total	7	8	7	8	4	5

Source: IMF/MCM survey

The relatively low development of equity markets in Central America is a trait shared with many smaller economies. The analysis above suggests that the equity markets in the region are neither a particularly good source of price discovery or raising new capital. Table 18 compares the size of capital markets in Central American countries with other countries with comparable GDP. Equity market capitalization in El Salvador and Panama, at around 40 percent of GDP, compares reasonably well with other small developing countries, but is quite low at 8.6 percent of GDP in Costa Rica.¹⁹ As mentioned earlier, El Salvador's market capitalization is perhaps somewhat inflated due to the public listing requirement imposed on financial intermediaries. Table 18 also allows a comparison of *the region* as a whole with *countries* with comparable GDP. In GDP terms, the region is comparable in size to Chile, Colombia, Israel, Malaysia, and Pakistan, whose equity market capitalization ranged from 36–156 percent of GDP. By contrast, the region's aggregate equity market capitalization amounted to under 12 percent of GDP. While a comparison between an incompletely integrated region and a country has many obvious limitations, it may be suggestive of both the difficulties of achieving equity markets of a viable size for smaller economies, and some of the potential gain from regional integration, a subject to which we revert later.

B. Incentives and Obstacles to Equity Issuance

The limited number of equity issues is the result of a number of causes which are common to the region as a whole. Problems are perceived to be more on the supply side than the demand side.

Supply side

- *Size of firms and family ownership:* The small size of regional economies and of most firms naturally limits the need or ability to raise equity financing through public issuance. Most of the firms that reach a critical size where equity issuance would be a possibility²⁰ belong to family groups and are tightly held. While a company can be relatively easily controlled with majority and certainly with a super-majority of shares, in Central America, there is a strong aversion to minority shareholders of any size. Therefore, there is very limited float in the market, including in some of the largest listed companies.

¹⁹ Table 18 also shows that there is great variation in the ratio of equity market capitalization to GDP across emerging markets and particularly across smaller economies, suggesting many other factors are responsible for market development beyond GDP level.

²⁰ 15 companies account for a market capitalization of \$11.4 billion, or more than \$750 million on average. By contrast, the bottom 64 listed issues account for a market capitalization of \$4.0 billion, with an average size only 1/10 of the top 15.

Table 18. Size of Emerging Capital Markets

	GDP	Equity Market Cap	Equity Market Capitalization	Bonds Outstanding	Private Bonds Outstanding	Equity + Priv Bond Markets
	(US\$ billion)	(US\$ billion)	(% of GDP)	(US\$ billion)	(US\$ billion)	(% of GDP)
China	2,630.1	1,144.4	43.5	1,212.9	421.6	59.5
Brazil	1,067.7	708.4	66.3	795.2	228.8	87.8
Russia	979.0	1,030.0	105.2	124.5	61.4	111.5
South Korea	888.3	815.1	91.8	1,110.8	643.2	164.2
India	886.9	816.5	92.1	345.7	40.8	96.7
Mexico	840.0	368.9	43.9	401.9	188.6	66.4
Turkey	392.4	154.0	39.2	226.4	8.7	41.5
Indonesia	364.2	137.3	37.7	105.8	20.5	43.3
Taiwan, Prov. of China	355.7	649.6	182.6	223.3	118.9	216.1
Saudi Arabia	348.6	322.8	92.6	3.4	-	92.6
Poland	338.7	148.5	43.8	160.7	6.4	45.8
South Africa	255.2	383.6	150.4	135.5	57.4	172.9
Argentina	212.7	399.7	187.9	137.5	22.6	198.5
Thailand	206.3	137.8	66.8	121.8	46.0	89.1
Hong Kong SAR	189.5	1,715.4	905.0	115.4	95.3	955.3
United Arab Emirates	168.3	138.6	82.4	31.9	31.1	100.8
Malaysia	150.9	235.1	155.8	178.5	115.6	232.4
Chile	145.2	168.6	116.1	49.9	31.6	137.9
Czech Republic	141.8	50.8	35.8	88.5	15.7	46.9
Israel	140.2	130.4	93.0	19.6	11.1	100.9
CENTRAL AMERICA	138.1	16.4	11.9	68.5	8.3	17.9
Colombia	135.1	52.1	38.6	60.9	1.9	40.0
Singapore	132.2	363.8	275.3	124.2	67.9	326.7
Pakistan	129.0	46.9	36.4	34.3	0.6	36.8
Romania	121.9	26.6	21.9	4.4	1.1	22.8
Philippines	116.9	67.9	58.1	77.0	11.6	68.0
Nigeria	115.4	27.8	24.1	n.a.	-	24.1
Hungary	114.3	42.3	37.0	87.1	14.7	49.9
Egypt	107.4	79.4	73.9	4.6	2.3	76.1
Ukraine	106.1	36.1	34.1	8.7	3.0	36.9
Kuwait	96.1	127.1	132.2	3.1	-	132.2
Peru	93.3	48.0	51.4	17.7	5.5	57.3
Morocco	57.4	48.2	84.0	0.5	-	84.0
Qatar	52.7	61.8	117.2	11.0	8.6	133.5
Croatia	42.5	29.0	68.2	14.3	0.9	70.4
Slovenia	37.3	15.4	41.2	2.0	0.2	41.8
Oman	36.0	12.9	35.9	1.2	-	35.9
<i>Guatemala</i>	35.3	-	-	8.9	0.1	0.4
<i>Dominican Republic</i>	31.6	-	-	13.1	0.2	0.6
Tunisia	30.6	4.4	14.5	3.5	-	14.5
Bulgaria	30.6	8.9	29.0	3.0	1.0	32.2
Lithuania	29.8	10.1	33.9	4.2	-	33.9
Kenya	23.2	9.7	41.9	n.a.	n.a.	n.a.
Lebanon	22.6	7.1	31.5	43.9	0.9	35.3
<i>Costa Rica</i>	21.4	1.8	8.6	15.0	5.0	31.9
Latvia	19.6	3.0	15.2	1.2	0.4	17.2
<i>El Salvador</i>	18.3	7.7	42.0	7.5	0.9	47.0
Cyprus	18.2	16.5	90.3	4.9	3.1	107.2
Estonia	16.4	5.7	34.9	1.8	1.6	44.8
<i>Panama</i>	17.1	6.8	39.8	12.5	2.1	52.0
Jordan	14.3	27.8	194.2	0.2	0.0	194.3
Ghana	12.9	1.2	9.7	n.a.	n.a.	n.a.
Zambia	10.9	1.0	8.9	n.a.	n.a.	n.a.
Jamaica	10.6	5.9	55.6	4.0	1.1	66.3
<i>Honduras</i>	9.0	-	-	3.5	0.0	0.0
Mauritius	6.4	3.4	53.7	0.2	-	53.7
Malta	6.1	1.8	29.9	0.3	-	29.9
<i>Nicaragua</i>	5.4	-	-	8.1	0.0	0.4
Barbados	3.4	0.3	7.5	0.8	0.4	17.8

Source: Local Exchanges, Bloomberg

- *International acquisitions:* Market participants suggest that for many of the larger firms, and especially for the banks, the apparent goal of the major owner/managers is to build up the company for eventual sale to foreign investors. Such whole business sale is an additional incentive to maintain nearly total control in the hands of founder and family members, and thus avoid public issuance.
- *Information:* As discussed earlier, there is a culture of secrecy regarding business practices and firm's financial statements, for both competitive and tax related reasons, and owners are reluctant to reveal information necessary for public offering.
- *Process of issuance:* As mentioned before, for a variety of reasons, the time required to obtain regulatory approval of an IPO can be very lengthy (up to 6 months or more) and uncertain despite rapid approval envisaged in the law,²¹ leading some companies to seek listings abroad (e.g., in El Salvador) rather than in their respective countries, or to obtain bank finance.
- *Cheap cost and ease of bank financing:* The current high level of liquidity in the regional banking systems implies relatively attractive loan financing. Together with the ease of bank loans (in terms of fewer disclosure requirements) and speed, this creates a weak environment for supply of equity securities. Many large firms that might issue equities also have tight relationships with banks and can extract favorable terms for loan financing. Many of these companies of critical size are usually part of financial conglomerates that set up their own bank, and get cheap financing at least up to the prudential limit of related borrowing. For other smaller firms, the fixed costs of issuance make debt financing more attractive.
- *Tax treatment:* As in most countries in the world, funding through debt results in a tax deductible expense. Although lower tax rates apply to listed companies (e.g., in Costa Rica and Panama) for most issuers, after-tax cost of servicing the debt seems lower than after-tax returns required for additional equity issuance as equity income is subject to multiple taxation (corporate income tax, dividends, and capital gains tax). In addition, as discussed earlier, private securities are subject to taxes that public securities are often exempt from,.
- *Lack of liquidity in the secondary market:* Secondary market trading in equity is extremely limited. For most equity issuers, this obviously reflects problems related to issuance, such as the lack of genuine free float, size, or lack of dematerialization. However, some potential issuers also suggest that this reduces their interest in equity issuance, as equity markets do not provide meaningful price discovery or exit options for large shareholders.

²¹ E.g., in El Salvador, where the law requires an approval within 15 days. However, the law also requires sequential presentation of the issuance documents first by the broker to the exchange and then by the exchange to the regulator.

Demand side

- *Under-development of regional institutional investors:* As discussed earlier, the regional institutional investor base is very weak. There are few mutual funds, fewer still with a mandate to invest in equity, resulting in paltry investment in equities. The same is true of pension funds, which face even stronger restrictions on equity investment. Thus, institutional investors neither provide a sufficiently strong demand, nor act as a mechanism of market discipline, in equity markets.
- *Lack of meaningful diversification:* The small and shrinking universe of corporate listings offers very poor diversification opportunities through investment in national securities. While a regional equity portfolio would improve the size and scale of diversification, constructing a regional position is currently not easy in the absence of a seamless market. Furthermore, for investors capable of doing so, it would be more interesting and perhaps less operationally difficult to access well-developed foreign markets than several fragmented regional markets. Similarly, foreign investors are likely to be uninterested in the regional markets in the absence of adequate size, depth and liquidity; absence of most regional markets from emerging market indices that serve as portfolio benchmarks; and the absence of any regional equity index.
- *Corporate governance and investor protection:* All of the real and perceived problems of poor corporate governance and investor protection act as a powerful constraint on investor demand. Although the supply constraints are more binding currently, these factors are likely to inhibit demand and the growth of equity markets over the long term.

VII. CORPORATE DEBT MARKETS

A. Current Status

The regional corporate debt markets are small overall and vary dramatically in size and importance across the region. Corporate bond markets have grown (Table 19) from \$6.3 billion in 2001 (6.6 percent of GDP) to \$8.3 billion in 2006 (6 percent of GDP). Costa Rica accounts for 60 percent of corporate debt securities outstanding in the region, with Panama being the distant second at 25 percent, and El Salvador the only other regional country with a measurable debt market. In Costa Rica, the debt market (in terms of outstanding book value) has grown steadily from \$3.0 billion in 2001 to \$5 billion in 2006. While Costa Rican market size (at 23 percent of GDP) compares well with other emerging markets. The markets in the Dominican Republic, Guatemala, and Honduras remain at an incipient stage, but there appears to be good growth momentum in the Dominican Republic.

Table 19. Central America: Corporate Debt Outstanding and Turnover

Total amount of outstanding debt (US\$ million)						
	2001	2002	2003	2004	2005	2006
Costa Rica	2,951	3,302	3,407	4,264	4,666	4,985
Dominican Republic	0	0	0	1	120	187
El Salvador	1,996	1,057	494	938	665	914
Guatemala	0	62	80	76	118	143
Honduras	0	0	0	0	0	3
Nicaragua	51	50	38	35	27	21
Panama	1,307	1,327	1,538	1,554	1,631	2,079
Total	6,305	5,798	5,557	6,868	7,227	8,332

Total amount of outstanding debt (percent of GDP)						
	2001	2002	2003	2004	2005	2006
Costa Rica	18.0	19.6	19.5	23.0	23.4	23.3
Dominican Republic	0.0	0.0	0.0	0.0	0.4	0.6
El Salvador	14.5	7.4	3.3	5.9	3.9	5.0
Guatemala	0.0	0.3	0.3	0.3	0.4	0.4
Honduras	0.0	0.0	0.0	0.0	0.0	0.0
Nicaragua	1.2	1.2	0.9	0.8	0.6	0.4
Panama	11.1	10.8	11.9	11.0	10.5	12.1
Total	6.6	5.9	5.7	6.5	5.7	6.0

Total traded volume during year (US\$ million)						
	2001	2002	2003	2004	2005	2006
Costa Rica	1,020	954	959	1,188	938	985
Dominican Republic	0	0	0	0	38	50
El Salvador	1,997	1,056	494	939	665	913
Guatemala	0	56	74	78	128	135
Honduras	0	0	0	0	0	0
Nicaragua	21	13	18	7	6	6
Panama	1,044	1,414	1,434	1,343	1,681	2,254
Total	4,082	3,494	2,979	3,555	3,456	4,343

Corporate debt (turnover ratios)						
	2001	2002	2003	2004	2005	2006
Costa Rica	34.2	30.5	28.6	31.0	21.0	20.4
Dominican Republic					63.5	32.7
El Salvador		69.2	63.7	131.1	82.9	115.7
Guatemala		181.9	104.6	99.6	132.0	103.2
Honduras						0.0
Nicaragua	43.8	25.7	40.9	20.2	20.3	23.9
Panama	80.9	107.4	100.1	86.9	105.6	121.5
Total	76.7	57.7	52.5	57.2	49.0	55.8

Source: IMF/MCM survey

Table 20. Central America: Corporate Debt Issuance and Delisting

	Number of companies with outstanding debt issues					
	2001	2002	2003	2004	2005	2006
Costa Rica	59	54	53	51	47	43
Dominican Republic	0	0	0	1	4	9
El Salvador	44	45	47	52	54	56
Guatemala	0	47	48	47	49	35
Honduras	0	0	0	0	0	2
Nicaragua	9	9	7	6	6	6
Panama	32	35	39	41	45	52
Total	144	190	194	198	205	203

	Number of new corporate debt issues					
	2001	2002	2003	2004	2005	2006
Costa Rica	56	45	36	67	57	43
Dominican Republic	0	0	0	0	0	0
El Salvador	12	5	20	13	14	18
Guatemala	0	3	1	3	4	2
Honduras	0	0	0	0	0	2
Nicaragua	1	2	1	0	2	1
Panama	8	12	8	14	18	22
Total	77	67	66	97	95	88

	Value of new corporate debt issues (US\$ million)					
	2001	2002	2003	2004	2005	2006
Costa Rica	141	121	134	307	719	261
Dominican Republic	0	0	0	1	120	77
El Salvador	2,247	865	11,163	1,608	5,850	70,258
Guatemala	0	26	2	74	157	13
Honduras	0	0	0	0	0	3
Nicaragua	1	3	5	0	2	10
Panama	138	356	166	329	634	835
Total	2,527	1,371	11,470	2,319	7,482	71,458

	Number of new companies that requested authorization for debt issuance during year					
	2001	2002	2003	2004	2005	2006
Costa Rica	3	3	2	3	0	3
El Salvador	0	0	0	1	5	10
Dominican Republic	3	0	0	2	5	2
Guatemala	0	3	1	3	4	2
Honduras	0	0	0	0	0	2
Nicaragua	1	2	1	0	2	1
Panama	2	1	1	6	4	7
Total	9	9	5	15	20	27

	Number of companies that requested delisting during year					
	2001	2002	2003	2004	2005	2006
Costa Rica	0	0	0	0	0	0
Dominican Republic	0	0	0	0	0	0
El Salvador	2	3	0	6	2	1
Guatemala	0	0	1	0	0	2
Honduras	0	0	0	0	0	0
Nicaragua	0	0	0	0	0	2
Panama	20	22	2	14	7	8
Total	22	25	3	20	9	13

Source: IMF/MCM survey

Regional corporate bond markets share several common features. First, there appears to be more liquidity in secondary bond markets than in equity markets. While Costa Rica leads in volume, Panama leads in terms of turnover ratio. Second, most issuers are financial institutions, mainly banks. Third, most corporate debt securities have short maturities, typically between 3 to 12 months. In some countries, though, it is possible to find maturities of up to 3 to 5 years. Issuance of asset-backed securities is minimal in the region. The exception is Panama, where there have been 12 securitizations, of which 11 are collateralized by mortgages. Most of the securitizations, however, correspond to just one issuer, a specialized lending company focused on housing for lower income families.

The institutional investor base varies from one country to the other, but is generally thin. Banks account for most of the demand for corporate debt securities. In some instances, bank demand is partly driven by tax incentives. Pension funds are important institutional investors in Costa Rica and El Salvador, and could play a potentially important role in the Dominican Republic and Honduras. In most regional countries, except the Dominican Republic, regulations bias the asset allocation toward government securities and impair the growth of the corporate debt market. As discussed before, mutual funds (except in Panama) and insurers play a limited role in investing in corporate bonds.

Foreign investors and high net worth individuals are important in select markets. Bond market data are scarce, but market conversations suggest significant foreign investor interest in El Salvador and Panama. Some of the mortgage and remittances securitizations structured locally were placed with foreign investors. Finally, high net worth individuals also invest in corporate debt securities. Generally, bond issues that target high net worth individuals are “pre-placed” ahead of the formal listing in the securities exchanges.

B. Incentives for Corporate Bond Issuance and Investment

Market environment

- The degree of dollarization and level of domestic interest rates, and broadly the confidence in the domestic currency and monetary arrangements, are important hurdles to the growth of domestic corporate bond markets. Panama and El Salvador are fully dollarized, while other countries have high levels of de facto dollarization. Thus, corporate debt issuance is divided between domestic and foreign currencies, making each market smaller, and external borrowings for the latter an important alternative.
- The growth of corporate bond markets is also hampered by several problems in the public debt management. These include high levels of debt in some countries, past problems with debt sustainability, fragmentation of sovereign debt issuance between governments and central banks, lack of a coherent public debt management strategy, issuance of non-tradable and nonstandard securities, and poor liquidity. These problems make it difficult to establish a good sovereign yield curve for pricing corporate securities (Shah et al, 2007).

- As discussed, financial disclosure in the region is generally poor. This prevents credit rating agencies from issuing investment grade ratings, even by local rating standards, to many issuers.
- All countries except Panama require a rating for public issues of corporate debt. In El Salvador, every debt issue requires a rating, and two ratings if the security is purchased by pension funds. Competition among rating agencies to secure a rating mandate is reported to lead to a “race to the bottom” at times. Given the low thresholds for capital and experience required by authorities to establish and to operate a rating agency, there are some concerns about the reliability and comparability of ratings issued by different agencies. Moreover, market participants are not always sophisticated enough to price different ratings or those issued by different agencies discriminatingly.
- Mark-to-market valuation of portfolios is seldom used in the region, and in some countries (i.e., Guatemala); loss recognition based on mark-to-market is not recognized by tax authorities. This creates incentives against regular trading and contributes to the low liquidity in the secondary market.

Supply side

- Many potential corporate issuers are part of family-controlled or part of conglomerates. Corporate control motives and the unwillingness to disclose information to outsiders favors “house” banking financing over market financing (see Section V). In addition, the financing needs of large “blue-chip” corporations are met in more developed external markets, which offer better rates and deeper pools of capital. Indeed, several important conglomerate members have raised market financing in the United States.
- Excess liquidity in the banking sector poses strong competition to all alternative funding including equity and bond markets. Currently, liquidity in the regional banking sector has been high due to favorable cyclical factors and strong flow of remittances, (exceeding ten percent of GDP in El Salvador, Honduras, Nicaragua, and Panama).
- The small size of most regional businesses, the small size of their funding needs, and the fixed costs of listing requirements, reduce the number of enterprises in each country for whom bond issuance is an economic alternative to bank financing. Moreover, while an issuance of, say, above \$5 million may be cost-effectively made, it is insufficient to create adequate liquidity in secondary markets and thus interest institutional investors.
- In some countries, certain legal and regulatory factors impede faster development of corporate bond markets. For instance, in Guatemala, only financial institutions are authorized to raise funds in public markets, and only if they have an investment grade rating. While disclosure requirements are generally moderate²², issuers complain of

²² Or weak, as in Guatemala, where private debt issuers are not required to disclose material events, nor to update the information in the prospectus.

fatigue due to excessively bureaucratic issuance authorization process and at times arbitrary and inconsistent treatment.²³ In addition, in Honduras, two credit ratings are required for investment by pension funds, whereas in Dominican Republic, two separate approvals by securities and pension regulators are required, which is onerous for most issuers.

Demand side

As mentioned earlier, the generally weak confidence in private securities, disclosure and enforcement of contracts depress demand from domestic and regional investors (see Section V).

- Corporate debt suffers also from some “crowding out” by government securities in most markets. Government securities enjoy several advantages over corporate debt securities. Foremost among them is the favorable tax treatment, i.e., lower tax rates or exemptions, on interest and capital gains from investments in government securities. Banks do not need to hold reserve requirements against government bond holdings, which is not usually the case for corporate debt securities. Public securities are also often much larger issues, more liquid, and offered more continuously. The “crowding out” trend would likely be reinforced as bank supervision practices in the region converge to Basel II.
- The average corporate debt issue is around \$50 million. This is not too small, but many issues are often well below this size and too small to satisfy the maximum concentration limits to be observed by pension funds, and often too illiquid for mutual and pension funds who must mark to market or need to trade.

VIII. ASSET-BACKED SECURITIES

A. Current Status

ABS markets in the region remain incipient. There have been a few transactions of domestic mortgage backed securities: 12 in Panama, 1 in Guatemala and a few in Costa Rica. In addition, there have been a few ad-hoc securitizations backed by cash flows, e.g., of auto loan and credit card receivables, factoring (IOUs), remittances from abroad and public infrastructure (Costa Rica). Many of these transactions have been structured abroad, use a foreign law, and are denominated in foreign currency. The large number of factors affecting debt markets adversely also discourages asset-backed securitization. But securitization also suffers from a few more specific problems within the region.

Problems in issuance of asset-backed securities

- Except for Costa Rica and Panama, the law poses material problems for the issuance of ABS. In El Salvador and Guatemala, there is no specific legal framework governing the issuance of ABS, though one is under consideration in El Salvador. In the Dominican

²³ As discussed above, some but not all regulators have tried to streamline the registration process, including deadlines for comments, for the authorization process and shelf registration systems.

Republic and Honduras, the laws contain very few provisions on securitization, therefore important issues such as bankruptcy remoteness are not explicitly contemplated. Trusts are the preferred vehicle for securitization in many countries, but trust laws do not exist in the Dominican Republic and Nicaragua and have important limitations on the type of intermediaries that can act as trustees (Honduras).

- In the face of the current large liquidity, regional banks lack strong economic incentives to securitize their assets. Many banks are eager to book and hold assets and value the size of their balance-sheets and regional market share rankings more than profitability, as size is often an important indicator of safety to the lay depositors.
- For several reasons, regional banks have had a wait and watch attitude toward ABS. Many regional banks lack the experience and expertise in issuance of asset-backed securities. As securitization transactions are also relatively new for the regulators, banks worry about the potentially longer delays and difficulties of receiving issuance authorization and rating for ABS, and prefer the relatively easier process for issuance of bonds. Many banks also prefer, for strategic reasons, to establish their bond issuance programs successfully prior to venturing in ABS arena. Others, aware of the imperfections in their underlying documentation and asset origination standards, prefer not to be exposed to the scrutiny of rating agencies and investors, until they have taken internal measures to clean up.
- As with many countries in the world, creation of a mortgage and transfer of assets attracts taxation based on the asset value or loan amount, and in some cases, financial transaction taxes on payments, resulting in multiple levels of taxation for the same underlying financing transaction. In some countries (the Dominican Republic), transfer of mortgages to the special purpose vehicle entails a significant additional stamp tax. In El Salvador, a special purpose vehicle collateralized by mortgages is also required to pay municipal taxes. In the Dominican Republic, ABS-related payment flows would attract financial transaction taxes. In Guatemala, net income from mortgages guaranteed by the Instituto de Fomento Habitacional (IFHA) is tax-exempt and the underlying mortgages are not subject to capital provisioning. As these provisions may not apply to an SPV, banks, therefore, have strong incentives to hold the mortgages in their loan books.
- Mortgages are not originated to common standards, even within individual banks, as is the case for mortgages in the Dominican Republic and Guatemala. In several countries, mortgages are linked to individual banks' deposit interest rates rather than an external interest rate benchmark. The low reliance on marking to market also can cause problems as sale of securitizable assets to the special purpose vehicle may create gains and losses, with tax implications.
- Finally, the quality of the infrastructure supporting the ABS market differs between countries. In Guatemala, for instance, the registration of mortgages is easy. In contrast, the obsolescence of the real estate property registrar in Nicaragua works against the introduction of real estate investment trusts and MBS.

Despite the very low level of ABS activity so far and the problems cited above, securitization represents one of the most important opportunities for developing domestic fixed income markets. The need for public debt sustainability limits the amount of sovereign debt. Corporate debt markets tend to be substantially smaller in emerging rather than mature capital markets and the growth rate of highly rated corporate securities issuance is likely to remain low in Central America for many reasons discussed earlier. In this context, ABS represent the most interesting opportunities for expansion of potentially highly rated securities that can offer pension and mutual funds, insurance companies and retail investors a high quality and diversified investment opportunity.

While many hurdles remain in development of this market segment, its potential is also becoming evident. Panama is a good example of the growth potential of ABS markets. In Panama, the legal and regulatory framework does not impede the issuance of ABS; relatively clear tax policies avoid double taxation of ABS instruments; there has been a good pipeline of relatively standardized mortgages; and full dollarization has helped secure interest of foreign investors. Under these favorable conditions, Panama has led the region in the number of securitizations backed by domestic assets, which were placed successfully with both domestic and foreign investors.

Several factors suggest potentially good growth rates in ABS starting from a low base. The takeover of several regional financial groups by foreign institutions bodes well for securitization. The global financial institutions are more likely to be more interested in maximizing return on equity than regional market shares, are more familiar with securitization techniques, and even in the current highly liquid environment, may be interested in securitization and fee-based income. Successful placement of initial transactions by leading institutions could encourage many others, who would not like to incur the costs of being the first movers, to follow suit.

IX. SCOPE FOR DEVELOPING CAPITAL MARKETS IN THE REGION

The seven Central American private capital markets are at a very low stage of development compared to advanced economies, but also with economies of comparable size, in terms of market capitalization, type and number of private financial securities available, and liquidity. The major structural and historical factors explaining the current state—political and economic uncertainties; banking, debt, and currency crises; small size of the economy; small size of businesses; family-owned businesses; and aversion to disclosure—are changing, but slowly. There are important gaps in the development of securities laws, regulatory agencies, and market infrastructure as well as in many of the basic pre-conditions for development of securities markets and more broadly financial system.

A. The Case for Policy Action

There are important costs of failure to develop more vigorous private capital markets for local businesses. The under-development of private capital markets is a major hindrance to external *equity* financing. However, it may not be a major hindrance to financing per se, and excessive reliance on banking system represents a deliberate and often a rational choice, for the vast majority of the relatively small regional businesses, say, less than \$25 million in financing. In the globalized world of today, the larger businesses (say, those needing financing of more than \$50 million) do not find it too difficult to access financial centers of Miami, New York, or in

Latin America. Thus, apart from the financing difficulties of the medium-sized businesses, the principal costs of poorly developed regional capital markets for local businesses may lie in generally lower valuations of their businesses, higher costs of financing, discontinuous growth prospects, and relatively greater difficulties of exit for principal shareholders.

The consequences may be worse for institutional and retail investors. For investors—particularly pension and mutual funds, insurers and retail investors—the lack of a well-developed capital market implies failure to attain a well-diversified portfolio of regional financial assets. This is a particularly important problem for institutions such as insurers or pension funds that must invest in regional assets because of regulation or currency preferences. To the extent that local investors may be presumed to be among the more willing and informed investors in regional private financial securities, they bear disproportionate costs of this under-development.

Banks may also suffer in the long run from a strategic weakness as a result of poorly developed capital markets. Banks may gain in the short run from under-developed capital markets, through a higher market share of financing. In the long run, such under-development may constrain the growth prospects of local banks, which must maintain an adequate access to external equity capital and long term borrowings. It also impedes the banks' ability to securitize their assets, which may be needed in an environment of tighter liquidity or capital adequacy.

A thin capital market may make several public policy choices more difficult. Small and illiquid Central American capital markets would undoubtedly reduce the degree of foreign portfolio investment in the region. Such markets would also raise the cost of policy-based restrictions in favor of domestic investments typically imposed on banks, pension funds, and insurers resulting in larger costs for affiliates, and greater possibilities of cherry-picking and front-running from investment of approved investible securities. Other implications may include poorer financing possibilities for housing or large infrastructure projects; reduced possibility of divestment or value realization in privatization; and greater concentration of risks in the banking system.

B. Limited scope for Developing Individual Country Capital Markets

The preceding discussion underscores that the development of the seven individual private securities markets is a difficult and complex challenge with no quick or simple solution. The fundamental issues of small size of individual economies, businesses, culture family ownership and aversion to minority shareholders, lack of equity culture among investors, et cetera cannot be resolved quickly.

In the four countries with no stock markets currently, investors and issuers alike may not have a realistic option to create a sustainable domestic stock market any time soon, and may be better off adopting a market in the region as their own. The Dominican Republic, Guatemala, Honduras, and Nicaragua, are unlikely to see more than a handful of equity issuance and listings per year in the near future. Given the uncertainties of equity approval process and the market reception and the limited investor base, issuers in these markets may well prefer to list in one of the more established exchanges of Costa Rica, El Salvador, or Panama. For investors in these four countries, stock markets that offer only a handful of stocks, with little float and liquidity, cannot provide a meaningful diversification possibility to retail or institutional investors who must explore investment opportunities abroad. For investors whose scale of investment, regulatory freedom, and sophistication permit investment in equity markets abroad, the latter are

likely to be so superior in terms of diversification possibilities, trading environment and liquidity, that their interest in domestic equity markets will become marginal.

Technical measures such as dual listing standards, aggressive promotion of public issuance to “targeted” companies, or tax incentives may all help, but are unlikely to result in a stock market that would reach a “take-off” stage. The regional listing standards are already very accommodating, and development of a “lower tier” equity market with even more liberal disclosure and approval standards is not a realistic option. Promotion by the relevant exchanges to coax new listings certainly has merit, but it is issuers’ unwillingness rather than failure of marketing that is the primary problem. While equity listings can be motivated through favorable tax treatment, it is preferable to remove unequal treatment rather than offer of new incentives. Thus, for the four countries with no stock market at the moment, it may be worth making a hard and realistic assessment of the merit of developing a domestic stock market versus essentially adopting one of the existing regional markets.

Proximity to the U.S. may also be an issue. The region’s proximity to the more developed financial markets in the US, the sizable diaspora present in the United States, dollarization, and the history of periodic economic turbulence have all created incentives to transfer or maintain savings abroad. The relative familiarity with the more developed U.S. markets and financial products raises the bar for investing in domestic securities.

Even the three better-developed markets may struggle for viability in an increasingly globalized world. Collectively, these three countries have 90 stocks, most of which are not at all liquid, and none of which carry a minimum free float. The total market capitalization (end-2006) was only about \$16.4 billion, with the top five stocks in each market (15 in all) accounting for about \$11.4 billion. While individually these exchanges are able to absorb issuances up to, say, \$50-100 million, they would be of limited interest to both large issuers and global investors. Thus, even if they survive individually, these stock markets are likely to struggle for viability without some form of integration. Under these circumstances, it may be worth examining if financing of corporations and investment in securities could be facilitated by bolstering the integration of the several small exchanges scattered across the region.

C. Scope for Regional Integration of Private Capital Markets

Given the limited number and size of issuers, it is worth considering the creation of a regional capital market, balancing the benefits from economies of scale with the cost of implementation and coordination. Such analysis merits a complete assessment that is beyond the scope of this paper. However, the paper discusses many elements that need to be discussed, including past experience with capital market integration and some possible steps forward to addressing the most important concerns.

International Experiences with Integrating Capital Markets

Past experience in mature and emerging market countries suggest powerful forces urging vertical and horizontal integration of securities exchanges and related services. In the United States, there were more than 100 regional exchanges in the late 1800s, the number fell to 18 by 1940 and 7 by 1980. Similarly, in India, although there are 22 regional stock exchanges, the two major ones attract around 90 percent of the trading volume, and many of the remaining regional exchanges have united under a common platform. There have been important cross-

border mergers and/or acquisitions, including Euronext (which has brought together the exchanges of Portugal, France, Belgium, and the Netherlands) and OMX (which has brought together the markets of the Nordic and Baltic countries) (Box 1), and more recently the case of NYSE and Euronext. There have been similar instances of mergers and integration of several CSDs.

At the same time, few of these examples can serve as a complete or easy “model” for the region. Each of them has very special features and contexts, and while regional authorities can draw some useful lessons from them, none of them would serve as a reasonably complete or relevant model for the region.

Challenges to developing a regional market in Central America

Central America would face particularly important challenges if it chose to integrate regional markets. The region is not fully integrated in terms of economies and monetary or fiscal policies. Unlike EU or ECCU, central American capital markets remain divided by in important respects, including currencies, restrictions on domestic institutional investors, the presence of as many as eight exchanges and custodians, the mutual structure of most exchanges, and presence of competing exchanges and custodians. To advance toward a regionally integrated market, substantially greater progress would need to be made toward harmonizing securities laws and regulation, approval and listing processes, supervision standards, disclosure and corporate governance norms. While a full study of these issues is beyond the scope of this effort, the following section touches on key issues and approaches to developing a regional strategy on capital market integration, if any.

Central American regulators and exchanges have already been considering some approaches to integration in recent years, but with limited success. The progress so far has been slow and these efforts reveal many important regulatory and operational differences; a lack of consensus (Box 2) on the need for, urgency of, or approach toward regional integration; and some important differences in confidence in the capacity of regulators across countries.

Box 1: Steps Toward Integration of Regional Capital Markets

While relevant to the entire region, so far most significant steps toward integration have been taken by the three countries with most developed securities markets: Costa Rica, El Salvador, and Panama. So far their initiatives have had limited success and concerned regulators and exchanges are now trying to advance the integration through a somewhat more systematic “regional” approach.

Regulators. The three regulators have tried a “fast track” approval of primary issuance of securities and mutual funds on a bilateral basis, so far with limited success. In 2003, El Salvador and Panama signed a memorandum of understanding (MoU) committing to a fast track registration. In addition Panama granted El Salvador the status of recognized jurisdiction. In practice, this mutual recognition has not worked well as Panamanian firms wishing to list in El Salvador have faced additional regulatory requirements. In 2003? El Salvador and Costa Rica signed another MoU, only to engage in best efforts to streamline the registration process. Thus, there was limited progress except clarifying the main differences between the two regulatory frameworks. In 2004 Panama and Costa Rica initiated the same process, but Costa Rica chose not to sign an MoU, preferring instead a move toward more uniform regional standards of issuance, supervision and enforcement, before entering into such agreements. However, in 2005, Panama unilaterally recognized Costa Rican jurisdiction allowing fast track registration of Costa Rican issuers in Panama. As of now, Panama has given a fast track registration to eight corporations and mutual funds originally registered in El Salvador and Costa Rica.

More recently regulators have started exploring the implications of regional integration, following the 2006 regional seminar by the Toronto Center. The Dominican Republic has proposed the creation of a Central American Institute of Securities Markets, along the lines of the Instituto Iberoamericano de Mercados de Capitales, a Spaniard learning center. In the absence of a full consensus, the regulators have agreed to create a council of Central American superintendents and requested a second seminar, facilitated by the Toronto Center, on global experience in capital market integration and the next steps for the region.

Security exchanges. Regional integration has been considered since the creation of Bolcen, the Association of central American and Caribbean stock exchanges, in 1994. Its main objective is to promote capital market development with the overarching goal of achieving one single market with inter-connected exchanges. However, so far there has been limited progress.

Separately, the stock exchanges of Costa Rica, El Salvador, and Panama have signed an MoU in September 2006 for the development of a common trading platform permitting member brokers to trade in real time in all three markets through correspondent local brokers. The goal was to have these arrangements developed by March of this year, and thus serve as a catalyst for regulatory action. However, technical problems such as different settlement conventions and the disagreement on the common trading have stalled the project. The exchanges agreed to seek the technical support from OMX -the operator of the Nordic exchanges. In parallel, the Panama Stock Exchange is also exploring an order- routing system with South American countries. Local intermediaries would place orders from their clients to buy and sell foreign exchange listed securities to those exchanges for a fee.

Box 2. Integration in Nordic/Baltic Securities Markets

The Nordic/Baltic region offers a good example of both the benefits and difficulties involved in consolidation securities exchanges and related CSD services. OMX began as a derivative exchange in 1985. Recognizing that the well-developed but small Nordic markets could not compete effectively in the long run against major European bourses, OMX merged with the Stockholm Stock Exchange in 1998, when a joint trading platform initiative started on all the Nordic exchanges.

While OMX's bid for LSE in 2000 was unsuccessful, efforts to create a unified Nordic market advanced, with common member and trading rules instituted in the Nordic region in 2001, merger of OMX and Helsinki stock exchange (including Tallinn and Riga exchanges already owned by HEX) in 2003, the acquisition of Vilnius Stock Exchange in 2004, and mergers with Copenhagen (2005) and Icelandic (2006) Stock Exchanges. Today, OMX is the 5th largest equity exchange and 3rd largest equity derivatives exchange and a global leader in exchange technology. OMX directly or indirectly also owns the Central Securities Depositories in most of these countries, and accounts for more than 80 percent of the exchange trading in the Nordic and Baltic countries. There has been some talk of including the Warsaw stock exchange. In 2007, OMX and NASDAQ announced their intention to combine the two companies.

The Nordic/Baltic exchanges benefits companies, members and investors alike. Listed companies gain exposure to a much broader investor base, exchange members enjoy more efficient access to trading a large number of securities and investors can easily choose among more investment alternatives than the pre-merger national exchanges did. All of this boosts trading, liquidity and market discipline and enhances corporate transparency.

Several aspects of the OMX experience may be relevant to Central America. The initiative was led largely by the private sector. The process was certainly difficult and entailed acquisition/merger of one exchange at a time, with CSD integration usually following. Some of the individual stock exchanges retained their separate legal identity, remain a subsidiary, and operate under different local securities laws and regulators. As with Central America, countries in the OMX umbrella do not have a common currency. OMX has dealt with these regulatory and brand distinctions, while reducing the operating differences between national markets, by sharing the same trading system, providing common listing and index structures, enabling efficient cross-border trading and settlement, offering cross-membership and providing one market source of information.

In some ways, Nordic/Baltic mergers were more difficult than future mergers in Central America could be. The countries and companies in the OMX group are much more diverse in size, did not have the same degree of political and regulatory cooperation that currently exists in Central America, and do not speak the same language. OMX has found practical solutions to these, e.g. by creating a two lists, Nordic and Baltic, with varying listing standards, and adopting English as its corporate language.

At the same time, OMX history suggests that the mergers of exchanges is a complex process that is likely to take years, and may require strong leadership. It also suggests that there may be several paths before an eventual creation of a single Central American market. For example, exchanges may continue to maintain their separate identity and ownership structures, while sharing a common technology platform, or two exchange groups (say, one combining Panama, Costa Rica, and El Salvador and another the other four) may emerge first, following by an eventual merger between them.

Securities regulators would have many legitimate concerns in dealing with cross-border integration of markets. Regulators have a mandate to protect investors, which they implement through a system of disclosure for issuers, prudential regulations for intermediaries, observance

of market conduct, and supervision. Allowing foreign issuers and/or intermediaries direct access to the local market under a different framework than that applicable to local players poses important concerns to regulators.²⁴

- Permitting foreign access to local investors without direct oversight would result in unknown risks to investors and capital markets, with the regulator possessing few or no powers to investigate or discipline foreign issuers or intermediaries.
- Such regional integration could be abused to seek regulatory arbitrage, with issuers and intermediaries registering in jurisdictions with weaker investor protection while still enjoying access to the local market.
- Local access to foreign players subject to very different frameworks might also make it difficult for local investors to understand the differences between the different investment options.
- There are important legal, political and reputation risks for the regulator if a scandal/fraud involving foreign issuers/intermediaries that access the market in different conditions than the same afforded to locals.

The regional integration process must address these regulatory concerns to be successful. The key elements would include: (i) comfort in the requirements established by the home country regulator; (ii) comfort with the capacity of the home country regulator for reviewing the information provided by issuers; (iii) a robust framework that permits exchange of information and cooperation; and (iv) regional legal frameworks that meet minimum standards of investor protection and regulatory authority. In this context, it is worth mentioning that the regional securities regulators have recently signed a memorandum of understanding (MoU) in order to share information and compromise the mutual cooperation and technical assistance as with the adoption of standardized processes and regulations based in international market principles. They also agreed to meet periodically and discuss integration efforts.

In addition, the region would face major operational challenges in integrating current variety of trading platforms and settlement systems. As discussed under market infrastructure, the regional exchanges do not share compatible platforms, and there are substantial variations in settlement cycles, degree and requirement of dematerialization, and degree of DVP. As the region does not share currencies, integration may require development of a platform that can trade and settle multiple currencies. While the technical solutions to these problems are feasible, the challenge lies in several regional exchanges, CSDs, settlement banks, and related institutions agreeing to collaborate toward a unified system, to share costs, and appoint a common management structure which would manage such a transition without any interruption of existing trading arrangements.

²⁴ See Tafari et al, 2007.

The transition toward a more harmonized and perhaps eventually integrated regulation may involve the following approach. Building on ongoing regional efforts, it may be reasonable to postulate a three-pronged strategy involving (i) incremental harmonization of regulation and supervision; (ii) mutual recognition of foreign securities and regulatory actions; and (iii) raising/converging regulatory capacity to regionally appropriate standards. In terms of harmonization, it would be most useful if the countries that need to develop new laws or regulation seek out regional counterparts with a similar need or prior experience in developing them, aim to introduce new laws and regulation that aspire to a good regional/international standard, and minimize national deviations from the regional standard to the greatest extent possible. Similarly, supervisory practices could be harmonized to the maximum extent possible in areas of common interest. As harmonization of regulation and supervisory practices meet certain norms, regulators could increasingly rely on regulatory actions (e.g., registration, licensing, and submission of periodic information and off site and on site supervision) by their counterparts. In parallel, regulators can also recognize certain jurisdictions—whose practices may differ in important respects—as providing adequate investor protection, and admit securities issued in such jurisdictions as tradable within their own markets.²⁵ Third, there would be a need to raise the capacity of all regulators (e.g., staff strength, quality, training, implementation of common manuals), and develop institutional mechanisms to consult among regulators and resolve issues that arise during transition. Third party consultants may be judiciously used to facilitate this process, and maintain regional commitment and confidence.

There may be some merit in phasing such regulatory convergence. Countries where the underlying law and regulation are better developed and whose markets are more active could take the lead in thinking through a harmonized legal and regulatory framework. Others may prefer to adopt the regulatory framework that results from such consultations. Similarly, there may be merits in phasing the application of harmonized regulatory standards to some brokers, issues, and markets before being extended to all issuers and markets.

A common regional securities market linking the seven Central American countries may make more sense than other possible configurations. While securities markets are integrating across countries for a variety of reasons, it may be legitimate to inquire if a common market for these seven countries is necessarily the dominant choice. The principal argument against may be reservations among the more developed markets about the magnitude of efforts required to bring up others to a regional standard, the greater economic incentives of the private sector in integrating with, say, a more developed market such as Mexico or Colombia versus those in the region, and the ease of bilaterally *adopting* a more developed market standards of a senior partner versus *negotiating* regional standards among seven more equal partners. These are all compelling considerations. Arguments in favor include the relatively small size of all seven regional economies compared to neighbors such as Colombia, Peru, Mexico or Venezuela, common language, physical proximity, political appeal and acceptance, other initiatives such as

²⁵ Ideally, this could involve a “blanket” acceptance of securities admitted to public issuance and trading in another jurisdiction, or may involve a fast track approval process, focusing more on disclosure to foreign jurisdictions but minimizing or eliminating a substantive approval process in another

common customs union and supervision of financial conglomerates, and the existence of regional political bodies and a regional association of exchanges. This is ultimately a choice for the regional policy makers and private sector. But it may be fair to say that while some top companies may be able to “graduate” eventually from Central American exchanges to a more developed foreign market, for the large majority of issuers, a regional securities market may be a more friendly marketplace than alternatives. Thus, if neither elimination of *all* exchanges in Central America nor continuance of seven national markets is a desirable outcome, it would stand to reason to strive toward a Central American marketplace.

The integrated market need not imply a single, physical location. This study is not sufficiently in-depth to offer detailed operational recommendations. However, a convergence of the regional markets need not only imply a single marketplace. Indeed, as the Nordic/Baltic experience suggests, it may entail maintenance of several exchanges linked to a common electronic platform, coupled with ownership and shareholding arrangements that may eventually replace multiple existing institutions. Such incremental convergence can take many paths that nonetheless offer substantial benefits of an essentially regional rather national market.

If a regional market is considered a desirable goal, regional authorities may need to take the lead in establishing the vision. The discussion above clearly underscores the need for strategic leadership and consensus by the regional authorities. National regulators and interested private sector representatives are likely to be too handicapped by a parochial vision, limited authority and perhaps conflicting interests, to successfully steer the process without a strong and clear political commitment. Such commitment is needed to ensure the necessary changes in the securities laws and even possibly a treaty to ensure a sound framework for regional integration, while empowering and tasking regulators and exchanges with the requisite regulatory and operational tasks. Operationally, this may mean adoption of a resolution by the political authorities and creation of a regional tripartite working group to spearhead the work. The analyses and groundwork underlying the existing initiatives and proposals could be harnessed, together with the necessary external support (e.g., of Toronto Center and/or interested IFIs) to jumpstart the process.

Articulating a vision for promoting regional integration of capital markets is a major and radical step. The problems in the process cannot be under-estimated, and the success is unlikely to be achieved without years of hard work. Yet, it does appear that without such an effort, the region may fail to achieve many of the benefits of an efficient and liquid capital market, and these opportunity costs warrant such an effort. This may require the authorities to resolve at the highest level their goal and vision for such facilitating an inter-linked market, lead in developing a consensus among the many regulators, private sector interests and institutions involved (no small task), and harmonize national securities laws in line with such a regional vision.

While private sector must have a lead role in arrangements relating to integrating marketplace, the public sector can provide powerful incentives for integration. The market participants, particularly in the smaller exchanges, already realize the somewhat dim prospects for growth and profitability within individual markets, and many are already positioning themselves through partnerships with regional counterparts. Second, a decisive signal by the authorities to harmonize varying regulation could provide just the powerful signal about the eventually

successful emergence of a regional market to align issuers, investors and intermediaries toward such a goal. Finally, it is worth recalling that about 90 percent of market capitalization and trading in securities is in government securities. Efforts by regional governments facilitating listing and trading in a shared or linked marketplace could be the most powerful driver of a regional integration process.

X. SPECIFIC RECOMMENDATIONS

A number of remedial measures could be considered to promote national and regional capital markets. However, such efforts should focus on removal of obstacles and expansion of potential opportunities, rather than direct promotion, tax concessions, or subsidies aimed at capital market transactions. The following chapters on individual countries deal with specific national measures, which are summarized in Table 21. In this section, we take stock of the more common measures as well as measures to develop regional capital markets.

A. Securities Laws and Regulation

Regional legal framework needs strengthening in several areas. Securities laws need to be updated in most countries, and overhauled in El Salvador. Securities laws need to be amended to provide better and clearer powers to regulators, over the market and its participants, widen the range of sanctions, and facilitate MoUs and exchange of information between regulators, as well as with the stock exchanges. Regulatory framework for mutual funds, asset-backed securitization, and derivatives need to be completed or thoroughly modernized in several countries, and particularly in Guatemala, Nicaragua, and El Salvador.

Table 21. Central America: Summary of Recommendations

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Regulator's capacity to effectively regulate and supervise the market							
Independence							
Create a securities regulator			X				
Review role and composition of the board	X	X	X		X	X	
Strengthen administrative independence by removing limitations on number and salaries of staff					X		X
Appoint Commissioner							X
Delink periods of commissioners from presidential periods					X		
Powers							
Securities Market Law	Amend	Amend	Revamp	Revamp			Amend
Provide explicit powers over brokerages	X						
Provide explicit powers over auditors	X						X
Provide explicit powers over rating agencies							X
Exchange of information		X					X
Disciplinary framework	X						X
Legal protection of staff							X
Resolve of gaps in regulation and supervision of issuances by financial institutions		X					X
Establish informal mechanisms to discuss issues with industry							X
Carry out diligences with Supreme Court to explain powers							X
Supervision and enforcement							
Implement risk-based supervision of securities intermediaries	X	Too limited activity to assessed	Enhance	Establish a securities regulator	Too limited activity to assessed	Too limited activity to assessed	Enhance
Implement a more active enforcement policy	X	Too limited activity to assessed		Establish a securities regulator	Too limited activity to assessed	Too limited activity to assessed	
Clarify responsibilities of the exchange via MoU or other document	X	X	X	X	X	X	X
Market infrastructure							
Trading							
Eliminate obligation to conduct repos through brokerage houses							
Work towards DVP		X	X	X	X	X	
Ratify Treaty on Payments	X	X	X	X	X	X	X
Central securities deposit							
Impose dematerialization and work on conversion of current physical securities		X	?	X	X	X	Prohibit reversion of dematerialization
Eliminate Central Bank custody		X					
Capitalize CSD		X					X
Price formation							
Develop mechanisms for appropriate price disclosure		X					
Develop a strategy for mark to market valuation of carteras de inversion			X				

Table 21. Central America: Summary of Recommendations (concluded)

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Legal and regulatory framework for issuance							
Equity issuers							
Strengthen disclosure requirements for equity issuers		Enhance public disclosure	X	X	X	X	X
Include disclosure of insider holdings			Stricter rules	X	X	X	X
Include disclosure of substantial holdings				X			
Include disclosure of material events				X			
Deadlines for disclosure		Establish	Shorten				
Enact code of corporate governance		X	X	X	Improve	X	Improve
Debt issuers							
Stop non-standard issues	Central Bank				Government, corps		
Strengthen disclosure requirements by ensuring timely disclosure of material events.			X				
Registration process							
Streamline registration process		X					
Improve coordination with Stock Exchange			X		X		X
Expand shelf registration of bonds							X
ABS							
ABS regulation	Clarify authority of public institutions to constitute trusts for ABS purposes	Strengthen ABS framework	Enact ABS law	Enact ABS law	Strengthen ABS framework	Develop regulations for ABS	
Develop standardized mortgage contracts		X					
Develop reference rate		X					
Issue regulations for marketing of foreign securities		X					
Legal and regulatory framework for investment in securities							
Mutual funds							
Issue mutual fund regulations		X			X	X	Review
Enact mutual fund law			X	X			
Reduce rating requirement for pension fund investment			X				
Phase out "carteras de inversión"			X				
Pension funds							
Allow investment in government debt		X					
Allow investment in foreign securities		X					
Eliminate a second, individual security approval for AFPs' investments and replace it by general criteria for approved investments		X					
Preconditions							
Commercial and corporate law							
Streamline process to constitute companies		X					
Streamline registration of mortgages		X			X		
Develop mechanisms for expedite execution of collateral	X		X				X
Modernize bankruptcy framework	X	X	X		X		X
Accounting, Auditing and Transparency							
Implement IFRS			X	X	Complete	X	
Consider the inclusion of thresholds for filing and auditing of financial statements	X	Review thresholds	X	X	X	X	X
Enhance auditors requirements and oversight	X	X	X	X	X	X	X
Taxation							
Review taxation framework of different financial products		Eliminate/clarify imposition of 4.3% tax at origination and transfer to the SPV	Review taxation issues on mutual funds draft law				
Remove tax on financial transactions		X					

B. Securities Regulators

There is a need to strengthen the budget and staff of securities regulators in El Salvador, Guatemala, Honduras, and Nicaragua. However, as discussed under regional integration, these regulators may wish to make maximum use of regulation, laws, and good supervision practices already available within the region and elsewhere, and develop required regulation jointly. We do not have specific recommendations on the regulatory structure (e.g., within or outside the central bank, or combined or single regulatory agency), save to say these arrangements should ensure a degree of independence to the regulators, and ability to attract and retain the right staff. The latter may require independence from civil service pay scales.

There is a need to substantially simplify and speed up issuance approval process in most of the region. The process is generally considered bureaucratic, lengthy, uncertain and involving multiple levels of scrutiny (between regulators and stock exchanges in all countries, and between two regulators in some). There is a need to make this process more efficient, time-bound and certain, without sacrificing thoroughness or lowering standards. Key measures would include setting business standards for responses and clearances, responding to all aspects of an application at one go, focusing on materiality rather than formality, eliminating scrutiny by multiple regulators in all cases, better coordination with the stock exchange. This should be supplemented with a proactive, regular, and business-like dialog with representative of issuers and investors to identify and address problems, and develop applications, criteria, and supervision approaches for new products jointly with market participants.

C. Developing Institutional and Retail Investor Bases

Further development of institutional investors, particularly mutual and pension funds, is needed to facilitate sound intermediation in securities market. Several countries still have important gaps in the basic enabling laws (El Salvador, Nicaragua, and Guatemala) for mutual funds, and some need to force and facilitate transition of poorly structured and regulated quasi-mutual funds into properly regulated mutual funds. Regulatory reforms in some countries (e.g. Guatemala) allowing private pension funds would facilitate the establishment of an institutional investor base. Also, there is potentially scope to relax investment restrictions on pension funds, particularly for foreign and private sector securities. Restrictions on pension fund products need to be reviewed comprehensively to permit offer of diverse portfolios suitable to different investors.

Further efforts are also needed to develop a retail investor base. The low income, past crises, and lack of investible securities have created a weak investor base. While the underlying structural problems of income, education, and lack of securities can be addressed only in the long term, there is also a need to invest in investor education regarding financial products such as equity, bonds, asset-backed securities, and mutual funds, and inform them of regulatory efforts to improve corporate governance, disclosure and safety of market conduct. Again, regional cooperation and development of standards and educational tools may be particularly efficient.

Corporate bond rating standards could be made more uniform across the region. Countries with no rating or multiple rating requirements (e.g., El Salvador, where pension funds are required to invest only in bonds with two ratings) should converge to requiring one rating. A mandatory

rating is needed in the region to improve transparency and pricing at this stage of the market, but requirements for two ratings is excessive for most of the regional issuers, and unnecessary for investment by institutional investors. The regional rating agencies are not of uniform quality, and there may be a need to gradually improve the capital and experience thresholds required from rating agencies, but such a move needs to be tempered given the low issuance activity within the region, and the low income of agencies. Standardization of rating agency accreditation criteria and facilitating agencies to operate regionally (e.g., through mutual recognition) could both improve rating standards and homogenize ratings across the region.

Several steps are needed to develop regulatory framework and market for ABS. Securitization represents the most promising step toward developing fixed income private markets in the region, given the presence now of several regional and foreign financial conglomerates with skill and interest in ABS, strong demand from even the limited base of institutional investors, and successful completion of several transactions in Panama. In some countries of the region (the Dominican Republic, El Salvador, Honduras, and Nicaragua), authorities still need to address important gaps in the current law or regulation. Most of the countries also need to resolve more subtle and specific gray areas or problems in tax treatment (particularly double taxation), inefficiency of registration or execution of collateral; bankruptcy remoteness; and borrower consent requirements.

Banks, institutional investors and financial regulators need to collaborate in improving standardization of mortgages and other securitizable assets, and related pricing norms. Such standardization is critical to facilitating future securitization, and there may be a role for moral suasion, fine-tuning of prudential parameters, and developing criteria for any government-supported mortgages or insurance to encourage such standardization. Finally, development of adequate pricing standards and methodology for more complex and structured products such as securitization is an important need. Development of regulation, standards, and pricing methodologies are all useful areas for further regional collaboration.

D. Development of Equity Markets

There is a need to promote development of a regional corporate governance code. While such a code should ideally be developed jointly by investors, issuers, regulators and government, the latter need to take substantial lead in making it happen. There is a need to encourage greater participation of minority shareholders in family-owned companies, and the discussions surrounding development of a corporate governance code could be used by the authorities and private business leaders to foster this change.

E. Market Infrastructure

Regulators, exchanges and CSDs could take several steps to improve the efficiency and security of exchanges. These measures could include requirement of dematerialization for new security issuance, a phased program to dematerialize existing securities (with the authorities taking prominent lead with respect to government and central bank debt), favoring a private sector led (but widely held) CSD, and eliminating requirements on specific investors (such as Asps in Dominican Republic) of holding securities outside CSDs. In some countries, CSDs need resources to be adequately capitalized and to implement needed technological upgrades, a

process that is severely hampered by current low volume of trading and resulting revenue. The authorities could facilitate these measures by reining in public sector banks or central banks from attempting to develop CSDs.

Improvements in DVP and settlement are needed in most countries. Several countries do not have DVP or settlement in central bank funds. More importantly, the settlement practices vary across exchanges and these differences are an important operational hurdle to be overcome in successfully linking or integrating the regional exchanges. With the emergence of regional financial groups, a region-wide settlement bank is easier to find.

F. Broader Policy Measures

There is a need to eliminate uneven taxation of securities income. In particular, relative tax concessions aimed at public securities and bank deposits should be reviewed and either extended to income from private securities or all such income should be taxed uniformly. Second, there is a need to improve general tax collection to a point that successful tax avoidance and maintenance of two books of accounts are not a serious impediment to public issuance of private securities.

Governments should consider eliminating unnecessary incentives to “promote” capital markets. In particular, concessions and regulations aimed at conducting repo transactions through the stock exchanges for institutional investors, issuance of public debt through the stock exchange (which generate fees for the exchange and brokers), and requiring pension funds to deal through brokers in primary markets, may be phased out. While these measures might have been useful to jump start exchanges and brokers in the past, they are not necessarily rational or value-additive for markets today. Such changes should be phased in without reducing price transparency and prices of both on- and off-exchange transactions should be captured, consolidated, and disseminated timely.

Instead, the governments could consider supporting private capital markets through several measures in public debt management, infrastructure financing, or privatization. Key measures include increasing the share of standardized, tradable portion of the public debt; consolidating public debt both across issues and between the central bank and the government; developing a domestic yield curve; dematerializing government securities, and facilitating retail investment in public debt. Another important policy tool could be the use of securitization techniques for infrastructure financing. In addition, governments could support equity market development through full or partial privatization of large state-owned companies (especially utilities) through the exchanges, without necessarily eliminating a strategic buyer, and setting high standards of disclosure and corporate governance.

More generally, government should continue to work on improving the business environment. As noted in this report improvements are needed in all areas. However, for the development of securities markets, the most critical issues are: improving the accounting and auditing framework applicable to all corporations, the legal framework for the constitution and execution of collateral; as well as insolvency proceedings. Some of these issues would require changes in the judiciary.

Appendix 1. Country Studies: Costa Rica

A. Overview of the Financial Sector

The financial sector is dominated by state-owned banks, although the importance of private financial groups is growing steadily. Until 2005 most private financial groups belonged to regionally owned banking conglomerates, but these have recently been acquired by international financial groups. This may help the development of new financial products.

While not large, the securities market is relatively active. The equity market is very small with only 18 issuers in 2006 and a market capitalization of US\$1,841 million (8.6 percent of GDP—Table 22). The corporate debt market is larger, with 43 private debt issuers with an outstanding value of US\$4.9 billion as of December 2006 (23.3 percent of GDP—Table 23). Securitization issues related to mortgage portfolios and public infrastructure have existed since 2002. Repos on government debt securities comprise most of the trading volume of the Bolsa Nacional de Valores (BNV), the only securities exchange. The mutual fund industry is relatively developed, although it experienced a crisis in 2004 from which it has only recently started to recover. As of December 2006, there were 128 funds managing US\$1,569 million in assets. Real state funds are becoming a popular product. Private pension funds have also developed, with 24 pension funds managing US\$1,502 million at December 2006. The insurance sector remains a state monopoly.

Table 22. Costa Rica: Financial Intermediaries

	2001	2002	2003	2004	2005	2006
Number of authorized mutual fund managers	23	21	22	21	18	21
Number of authorized pension fund managers	9	9	8	8	8	8
Number of authorized investment advisors	...	...	...	...	...	...
Number of authorized banks	23	23	17	19	17	17
Number of authorized stock brokers	23	22	20	20	20	20
Number of authorized insurance companies	1	1	1	1	1	1
Other	...	...	...	...	...	...

Source: IMF/MCM survey

Table 23. Costa Rica: Mutual and Pension Funds

Mutual Funds	2001	2002	2003	2004	2005	2006
Total number of Mutual Funds authorized for PO	129	131	144	135	131	128
Assets under Management (US\$ million)	1618	1787	2813	1346	1254	1569
Assets under Management (percent of GDP)	9.9	10.6	16.1	7.2	6.3	7.3
Percent of net assets invested in local equities	0.5	0.3	0.2	0.2	0.1	0.1
Percent of net assets invested in local corporate debt	3.9	4.2	4.8	2.9	2.5	4.6
Percent of net assets invested in foreign securities	...	...	...	...	...	...
Pension Funds	2001	2002	2003	2004	2005	2006
Number of authorized pension funds	32	27	26	24	24	24
Assets under Management (US\$ million)	559	772	1,034	830	1,112	1,502
Assets under Management (percent of GDP)	3.4	4.6	5.9	4.5	5.6	7.0
Percent of net assets invested in local equities	...	0.0	0.1	0.1	0.1	0.3
Percent of net assets invested in local corporate debt	...	13.0	15.0	19.0	17.0	18.0
Percent of net assets invested in foreign securities	...	...	...	...	...	...

Source: IMF/MCM survey

There are three specialized regulators, (SUGEF, the SUGEVAL and the SUPEN), under the aegis of the central bank. The regulators supervise banks and other credit institutions, securities markets and pension funds respectively. Although dependencies of the central bank, they share a common board, which is separate from the central bank's board of directors. In practice, coordination and exchange of information between the regulators is still a challenge, but the existence of a common board and the creation of a committee of Superintendents has led to improvements.

A. The Securities Regulator

Independence, resources and powers

Despite being a dependency of the central bank, the existence of a separate common board for the regulators provides a measure of independence. The existence of the board has allowed for a more coordinated regulation of the financial sector, but in practice "banking" goals and views have prevailed. There are some concerns that the inclusion of the President of the central bank and the Minister of Finance in the common board may limit the independence of the regulators, although it has enabled coordination with the monetary authorities.

This organizational structure has given the regulator a larger resource envelope than other public sector dependencies. Eighty percent of SUGEVAL's budget is funded by the central bank and 20 percent by levies on market participants, allowing it to have better funding, salaries and employment regulations than those of most other public employees. As of February 2007, the SUGEVAL had 107 staff and its budget for 2006 amounted to roughly US\$4 million, making it the second largest in the region.

The Ley Reguladora del Mercado de Valores (LRMV) provides the SUGEVAL with sufficient powers to regulate and supervise the market. However, there are deficiencies in specific areas: (i) the power to license brokerage houses; (ii) the power to oversee external auditors (which has allowed questioning of the regulations that the SUGEVAL has issued in this area); and (iii) the enforcement framework (definition of administrative infractions and criminal conducts and the range of available sanctions).

Practice

While a good framework for supervision exists, there are some weaknesses in implementation. The SUGEVAL has issued most necessary regulations for implementing the LRMV, including for equity, corporate debt and securitization, and for mutual funds. It has made some effort to streamline the process of authorization of new issuers, including by setting a deadline for the initial review of all documents and the provision to the issuer of a single list of comments, as well as a deadline of one month for the whole process. However, high staff rotation and a formalistic approach results in issuers suffering from delays and having to address comments on non material issues. SUGEVAL has also implemented a risk based approach for the supervision of issuers, mutual funds and fund managers, and is in the last stages of design for implementing a similar approach to brokerage houses. However, overall enforcement appears to be weak, due in part to the limitations of the disciplinary framework (e.g., in the definition and enforcement of sanctions).

Self-regulatory organizations

Currently there is no formal delimitation of the responsibilities of the securities exchange vis-à-vis the SUGEVAL. By Law the securities exchange (Bolsa Nacional de Valores—BNV) is a self-regulated organization (SRO) under the oversight of the SUGEVAL. In practice the BNV is the “front line” regulator and supervisor for market trading and market conduct rules applicable to brokerage houses, while the SUGEVAL acts to enforce prudential requirements applicable to brokerage houses and the BNV.

B. Securities Intermediaries

There is a well established legal framework for intermediaries. Brokerage services can only be carried out by brokerage houses; mutual funds must be managed by mutual fund managers; and voluntary and mandated retirement systems by pension fund managers. Banks can provide all other services. The legal framework requires a holding company at the top.

Both the banking and the brokerage industry are experiencing consolidation. The number of banks has declined from 23 in 2002 to 17 in 2006; the number of brokerage houses from 27 in 2000 to 20 in 2006 and the number of fund managers from 19 to 15. The number of pension fund managers has remained the same since 2002, with 8 managers.

C. Market Infrastructure

Trading systems

Trading systems are relatively well developed. According to the LRMV only mutualized securities exchanges can operate trading systems. All secondary market operations with securities authorized for public offering, including repos, have to go through brokerage houses on the securities exchange. This has hindered the development of an efficient money market. Currently there are three money markets: one at the BNV that uses repos up to 3 months; a money market between brokerage houses that uses 1 day repos; and an interbank money market between the central bank and commercial banks that uses collateralized loans.

The BNV is the only securities exchange. Trading systems are fully automated.²⁶ The system for secondary market operations is continuous, order driven and operates with multilateral netting, with settlement in $t + 3$ for equity and $t + 1$ for debt. Risks from the cash leg are managed through a settlement fund financed by “levies” on the brokerage houses and from the securities leg through the blocking of securities after the trade has been perfected. The system has achieved DvP, though not for all transactions.

Depository and book-entry services

In practice all exchange traded securities are dematerialized. Dematerialization is voluntary but irreversible. Most government and private issues have been dematerialized since the early 2000s. For older securities, immobilization in the BNV is required for trading leading to

²⁶ The BNV has just implemented a new trading system.

dematerialization in practice. The central bank manages the electronic book-entry system for public debt, while the Central de Valores (CEVAL), a subsidiary of the BNV, manages the electronic book-entry system for private securities and is also the depository for public debt issued before December 2006. The central bank is pursuing an amendment to the LRMV to allow it to manage the book-entry system for private securities.

Rating agencies

Rating agencies are subject to licensing by SUGEVAL. The legal framework requires constitution of a company in Costa Rica, which hinders the possibility to use international rating agencies. There are two rating agencies licensed by the SUGEVAL, including Fitch.

Price vendors

The Superintendency has encouraged the securities exchange to develop a pricing vector, and it is acting as pricing vendor for the industry. The three Superintendencies have developed common regulations for valuation of pension fund, mutual fund and bank portfolios. Regulations do not prescribe a single methodology for the whole financial sector, but do require that all participants from the same financial group use the same methodology to value the portfolios they manage (thus, the mutual fund, pension fund and bank of the same group will use the same methodology). Problems in the pricing vector might have played a part in the 2004 crisis of the mutual fund industry, but the BNV has continued to work on improving the methodology. Operationally, the BNV has created two committees to deal with pricing issues: one to deal with changes to the methodology with participation of the industry; and another to deal with price disputes with participation of external parties. A new price vendor, Promotora Integral de Precios de Centroamericana (PIPCA), a company with Mexican capital, is in the process of registering a methodology.

D. Investor Base

Institutional investors are important players in the market. Although the specific data is not available, direct retail investment is not significant.

Mutual funds

The SUGEVAL has issued a regulatory framework for mutual funds. Overall the only limitation to investible assets of financial funds derives from the LRMV, which prohibits mutual funds from investing in securities that are not authorized for public offering, except via a specialized vehicle known as *fondos de capital de riesgo*. Up until 2006 real state funds could only be used to buy buildings for lease located in Costa Rica. The current regulations allow funds to buy properties located abroad as well as to develop infrastructure projects.

The mutual fund industry is recovering from recent turmoil. It developed significantly from 1998 until its peak in 2003, when it represented roughly 17 percent GDP. In 2004, a drastic adjustment in the price of Costa Rican bonds—in which financial funds were highly concentrated—provoked losses that led to a massive run of investors. As a result assets under management declined to around seven percent of GDP. The industry began to recover in 2006, with AUM of US\$1,569 million (7.3 percent of GDP) by December. Money market funds (half the total of

assets under management) and real estate funds (30 percent of assets) are the fastest growing products in the mutual fund industry.

Pension funds

Costa Rica conducted a pension sector reform in the 1990s to a three pillar approach. The *Caja Costarricense de Seguro Social*, a public entity, administers the first pillar, under a defined benefit system funded by mandatory contributions from employers and employees. The second pillar, funded by mandatory contributions of employers and employees, is managed by pension fund managers, under individual accounts. The third pillar comprises voluntary pension fund accounts also administered by pension fund managers, with a favorable tax treatment. At December 2006 AUM amounted to US\$1,502 million.

There is a well developed legal and regulatory framework for pension funds. Pension funds are allowed to invest in foreign securities, through the BNV or directly in organized markets under certain conditions. An investment grade rating is required. Until 2004 most pension funds were heavily concentrated in Costa Rica bonds and, as was the case for mutual funds, experienced some losses. After the crisis, the SUPEN introduced new regulations to foster diversification. As a result pension fund managers changed portfolio composition and invested more abroad. Currently investments abroad represent roughly 40 percent of assets under management.

Insurance companies

Costa Rica has a state monopoly in the insurance sector. The *Instituto Nacional de Seguros*, a public entity, is the monopoly insurer, although the distribution and sale of its products through brokerages has been privatized.²⁷ Under the CAFTA-DR, still not ratified in Costa Rica, it's the insurance sector will be opened to foreign competition.

E. Equity Markets

Key indicators

The equity market is small and shrinking. There are very few equity issuers and as a result of mergers and acquisitions the number has declined from 23 in 2000 to 18 in 2006. All except one are non financial corporations. There have not been initial public offerings (IPOs) in the last two years. Market capitalization amounted to US\$1,841 million (8.6 percent GDP) in December 2006. The market is highly concentrated, with capitalization of the five largest companies amounting roughly to 7 percent GDP. There is virtually no secondary market, and trading volume has decreased from US \$ 64.5 million in 2000 to US \$ 24.5 million in 2006.

²⁷ It is worth noting that the distribution and sale of insurance products for the state monopoly INS is still mostly conducted by INS employees, so it has not been fully privatized.

Table 24. Costa Rica: Equity Markets

	2001	2002	2003	2004	2005	2006
Number of companies with outstanding equity issues	25	22	20	22	20	18
of which: -financial	10	3	3	2	1	1
of which: non-financial	15	19	17	20	19	17
Number of listed companies	25	22	20	22	20	18
of which: -financial	10	3	3	2	1	1
of which: non-financial	15	19	17	20	19	17
Number of IPOs	5	1	3	2	0	0
Value of IPOs:	60.5	200.3	45.9	12.6	0	0
Number of companies that requested cancelation of registration before regulator	3	4	5	0	2	2
Number of companies that requested delisting during year	3	4	5	0	2	2
Equity Market capitalization (US\$ millions)	2,466	2,141	1,696	1,406	1,417	1,841
of the 5 top companies	2,021	1,810	1,436	1,189	1,228	1,527
Equity Market capitalization (percent of GDP)	15.0	12.7	9.7	7.6	7.1	8.6
of the 5 top companies	12.3	10.7	8.2	6.4	6.2	7.1
Trading volume (in US \$ million)	86	81	33	45	28	25
Turnover ratio (in percent)		3.5	1.7	2.9	2.0	1.5

Source: IMF/MCM survey

Disclosure and corporate governance requirements

SUGEVAL's disclosure requirements are broadly in line with international standards.

Minority rights are covered by provisions in the Commercial Code applicable to all joint stock companies. In addition, the LRMV requires a mandatory tender offer for the acquisition of control in a listed company, and public disclosure of insider and substantial holdings. In 2007 the BNV, in collaboration with the Chamber of Issuers, developed a code of corporate governance under a voluntary approach. Participants believe there have been cases of insider trading and market manipulation, but the SUGEVAL has not taken any disciplinary action. There is no minimum float requirement. Listing involves a separate authorization by the BNV, but the BNV has not added substantive requirements to those imposed by the SUGEVAL.

Incentives for, and obstacles to, equity issuance and investment

The limited number of listed companies is the result of a multiple causes, many of them shared by the region as a whole. Family-owned companies still prevail and with them an aversion to give up control. The business model followed by many family-owned companies focuses on the eventual sale of the company rather than on increasing the scale of operations. Consequently, family-owned companies do not typically seek capital through IPOs. In addition, inadequate financial transparency and possible tax avoidance may also deter public issuance. The small size of most Costa Rican companies and costs of disclosure also encourage the use of bank funding instead of the securities market. Equity issuers also find the authorization process cumbersome. Finally, the tax system favors debt over equity financing, as the former benefits from a tax shield.

The authorities have contemplated measures to reverse the decline of the market. The BNV has considered the development of a market for "medium size enterprises," based on the experience of the OFEX market in Great Britain. The main features of this market would be a lighter disclosure regime and the establishment of "sponsors," which would be brokerage houses or larger and more experienced firms that would assist the smaller companies in their initial issues as well in periodic compliance. Given the lighter disclosure regime, this would be a market of private offering and thus, under the current framework, institutional investors could not access these issuers directly, but only through an investment in *fondos de capital de riesgo*. For

companies already listed in the BNV the lack of liquidity of the equity market implies few additional benefits in terms of future access and additional costs if they want to exit the market. To prevent the exodus of such companies the BNV has developed a pilot project for the establishment of market makers. At this stage participation is voluntary and there are currently only two brokerage houses in the program. It is still early to assess the impact of this project.

Privatization could be another option to activate the equity market. However, while there are still large government-owned banks and utilities companies in Costa Rica, it is widely regarded that their privatization is unlikely, at least in the near- and medium-term. Thus the stock market faces grim prospects.

F. Corporate Bond Markets

Key indicators

Corporate bond markets, though larger, have also been shrinking. Although debt issuers greatly outnumber equity issuers, they have declined from 64 in 2000 to 43 in 2006. As of December 2006 the outstanding value of debt issued on the securities market amounted to US\$4,985 million. The secondary market lacks liquidity, although total traded volume has increased from US\$557 million in 2000 to US\$985 million in 2006.

Disclosure requirements

Disclosure requirements are reasonable by international standards. As in other emerging markets, one rating is mandatory for debt issuances and equity issuances that are considered debt according to accounting principles. Listing involves a separate authorization by the BNV, but it has not added substantive requirements to those imposed by the SUGEVAL.

Table 25. Costa Rica: Debt Markets

	2001	2002	2003	2004	2005	2006
Number of companies with outstanding issues authorized for PO	59	54	53	51	47	43
of which: -financial	34	32	31	31	29	29
of which: non-financial	25	22	22	20	18	14
Number of issues to date	...	...	...	...	...	...
Total amount of outstanding debt (US\$ million)	2,951	3,302	3,407	4,264	4,666	4,985
Total amount of outstanding debt (percent of GDP)	18.0	19.6	19.5	23.0	23.4	23.3
Maturity: Less than a year	...	...	...	...	...	...
Maturity: Between one and five years	...	...	...	...	...	...
Maturity: More than five years	...	...	...	...	...	...
Number of companies that requested authorization for PO during year	3	3	2	3	0	3
Number of new corporate debt issues authorized for PO	56	45	36	67	57	43
Value of new issues authorized for PO (US\$ million)	141	121	134	307	719	261
Number of companies that requested cancelation of registration before regulator	0	5	2	1	4	4
Number of companies that requested delisting during year	...	...	...	...	...	...
Total traded volume during year (US\$ million)	1,020	954	959	1,188	938	985
Turnover ratio (in percent)	34.2	30.5	28.6	31.0	21.0	20.4

Source: IMF/MCM survey

Incentives for, and obstacles to corporate bond issuance and investment

There are a number of important impediments to the development of corporate debt markets. Although the government has issued Eurobonds up to 15 years, the lack of a liquid sovereign yield curve is a significant impediment. Nonstandardized issuances and fragmentation of sovereign debt between the central bank and the Ministry of Finance are also major problems. In

addition the central bank has complicated recent efforts to standardize debt issuance with the opening of an electronic window offering non standardized securities to investors. It is also seeking an amendment to the LRMV to allow institutional investors to access this non standardized paper. If implemented, these measures are likely to further drain liquidity from an already illiquid market.

The SUGEVAL has made an important effort to streamline the authorization process for corporate debt. It has instituted “shelf registration” procedures to allow for speedier registration of issuers with debt issuances programs. Thus the general opinion is that the process of plain vanilla bonds is straightforward, although the process is more protracted for more sophisticated products. Nevertheless, the complicated issuance procedures and the lack of liquidity of the bond market make it more attractive for firms to access bank financing, especially when banks are flush with liquidity and interest rates are low.

Problems in issuance of asset-backed securities

The market for ABS is developing. *Banco de San Jose* did the first mortgage securitization in the late 1990s, though via a private placement in the international markets. At the local level *Banco Nacional de Costa Rica* (BN) has securitized its mortgage portfolio. BN has also structured two securitizations of public infrastructure revenues for the construction of two hydroelectric plants. It is currently working in the development of a securitization program for housing loans of the saving and loans entities (*mutuales*) which have the guarantee of the *Banco Hipotecario de la Vivienda*, a second-floor state owned bank. In addition, BN believes that more securitization issuances of public infrastructure—including building developments for public institutions—will take place; in fact it expects to take four projects to the market during 2007.

There are no major problems in the legal framework for asset-backed securities. Up until 2006 Costa Rica did not have a complete legal framework for securitization, but SUGEVAL has recently enacted specific regulations for ABS issuance that completed the general framework. The new regulations have created alternatives to structure securitization issuances and the SUGEVAL is in the process of drafting complimentary regulations. However, special legislation applicable to public entities still requires them to obtain legal authorization every time they want to form a trust. While this new legal framework introduced by SUGEVAL seems to solve the issue, participants have recommended that it be clarified.

The preconditions for ABS operations exist. Mortgage loans in most banks are now standardized. Most banks provide lending in dollars at variable rates referenced to the *tasa basica pasiva*,²⁸ with 15-20 years maturity. However banks have not seen securitization as a good business opportunity, especially in an environment of excess liquidity. Market participants believe that the entry of international conglomerates might change this view, increasing the focus on returns on equity rather than asset size and provide impetus for ABS.

²⁸ An average short-term borrowing rate for the whole financial system calculated by the central bank.

G. Preconditions

Company law

The main deficiencies in the legal framework relate to the enforcement of collateral and the bankruptcy framework. Enforcement of collateral suffers from lengthy and unpredictable judicial process, particularly with regard to the foreclosure of movable assets. While not a complete solution, market participants are relying more on a security trust (*fideicomiso de garantia*) for more expedient enforcement. The framework for corporate debt restructuring and insolvency also has significant problems, including lengthy judicial processes; excessive protection of debtors; lack of incentives for creditors participation and unclear rules for extrajudicial workouts.

Financial transparency

IFRS apply, but the level of compliance and transparency are rather low. Companies are not required to publish their financial statements, nor to audit them, except companies in the financial sector. Requirements for auditors are relatively low, since only a college degree and two years experience is required. In addition, oversight by the *Colegio de Contadores Publicos* is perceived to be very weak. The Superintendencies have established stricter requirements relating to accounting and auditing of financial intermediaries and listed companies, including a registry of external auditors. This framework was challenged in the Supreme Court which already upheld the creation of the Registry and other related rules.

Taxation of financial instruments

There appear to be important distortions in the taxation framework. Interest on government debt and debt issued by certain public entities –including the state owned banks- has a better tax treatment than interest on corporate debt. There are significant differences in the tax treatment of private debt depending on the currency and the specific institution issuing it. In the case of corporate debt, the rate is 8 percent on interest from listed securities and 15 percent on interest from non listed securities. In the past, the tax authorities have questioned the ability of registered companies to deduct the interest they pay to investors. This issue has finally been resolved by the appellate courts in favor of companies. Distribution of dividends is taxed, thus subjecting companies to a “double taxation.” For equity issuers listed in the BNV the rate is 5 percent while for non listed companies it is 15 percent. As for ABS, there are different tax treatments depending on the type of special purpose vehicle (SPV) used for securitization. For example transfer of assets is exempt of taxes if done via a trust, but not via a mutual fund or a stock company. Mutual funds have a separate tax treatment and so do pension funds.

Regional Integration

The SUGEVAL has been hesitant to move forward with regional integration. While cognizant of the benefits, it has had reservations about the mechanism proposed, which contemplate a system of mutual recognition of each countries standards. SUGEVAL prefers the development of more uniform standards of issuance, supervision and enforcement across the region before integration can take place. In addition, SUGEVAL believes the current legal framework would not allow it to enter into such type of arrangements. It has only signed a MoU with El Salvador under which

it committed to engage in best efforts to streamline the authorization process for the issuance and listing of firms from the other country. A similar MoU was explored with Panama, but the SUGEVAL decided against it. Panama in turn has unilaterally given Costa Rica the category of recognized jurisdiction which allows Costa Rican issuers to use a fast track for registration in Panama. The securities exchanges of Costa Rica, El Salvador, and Panama also signed an MoU in September of 2006 for the development of a common trading platform. The goal was to have these arrangements in place by March of 2007. However the project has encountered technical problems and the exchanges have sought the support from OMX (The Nordic countries' exchange) to continue.

I. Recommendations

Regulatory capacity

Regulatory capacity can be strengthened in a number of areas. At the most general level, it would be recommended to review role and composition of CONASSIF (the board that oversees the three regulatory agencies) to increase SUGEVAL's independence. Strengthening the powers of the SUGEVAL would also improve regulatory capacity. In particular by:

- Providing it with licensing powers over brokerage houses;
- Clarifying its powers over new participants; and
- Strengthening the disciplinary and enforcement framework, by defining better infractions and increasing the range of sanctions available.

In addition, the SUGEVAL should make strides in implementing risk-based supervision of brokerage houses and improve overall enforcement of the regulatory framework. With respect to self regulatory organizations, it is necessary to clarify the division of responsibilities between the SUGEVAL and the BNV, possibly in an MoU or in the regulations for the BNV.

Market infrastructure

The principal recommendations for the development of market infrastructure include:

- Eliminate the obligation to conduct repo transactions through brokerage houses and in the securities exchange;
- The central bank should refrain from issuance of nonstandardized securities and implement broader solutions to create an efficient public debt market (see Central America Occasional Paper);
- Review the role of the central bank as electronic bookkeeper for private securities;
- Move toward DvP for all transactions; and
- Consider registration of foreign rating agencies.

Equity and corporate debt markets

While there are structural issues that need to be overcome for these markets to develop, the authorities can take some steps to improve the functioning of the markets that exist. For debt markets, an important step would be to develop a liquid public debt market to provide a benchmark for the corporate debt market, in particular to avoid small and/or non standardized issuances. Further streamlining the authorization process for issuances by focusing on materiality, and implementing tighter business standards would facilitate participation in the market.

Asset-backed securities

The ABS market is relatively more developed compared to the rest of Central America. Some steps to further improve its functioning include:

- Issue complimentary regulations for new law on securitization.
- Clarify authorization of public entities to use trusts for securitization purposes.

Preconditions

Improving the underlying preconditions for the development of a market economy is also important for the growth of securities markets. In particular, for the ABS market, which is expected to be the fastest growing securities market, improving the process of execution of collateral and amending the bankruptcy framework to allow for speedier proceedings and extrajudicial workouts would be important. For equity and debt securities, improving the information flow to investors and removing some of the incentives against participation in the market would be important. In particular:

- Consider requiring filing and auditing of financial statements for companies that reach a certain threshold size irrespective of whether they are listed or have issued bonds.
- Review tax policies toward different financial instruments and institutional investors with a view to making the tax regime more neutral with respect to the securities markets.
- Strengthen requirements to become an authorized public accountant as well as oversight mechanisms for public accountancy.

Appendix 2. Country Studies: Dominican Republic

A. Overview of the Financial Sector

As in other countries in the region, the financial sector is dominated by banks. There are 13 banks, including three foreign-owned banks, which together account for about two-thirds of financial sector assets (44 percent of GDP). There are also 18 savings and loans associations, accounting for 15 percent of assets, and about 85 other small credit intermediaries, accounting for 7 percent of assets, including five public intermediaries (the largest of which are *Banco Agrícola*, which provides loans for agriculture, and *Banco Nacional de Fomento a la Vivienda y Producción*, a second-tier mortgage bank that provides funds for housing and infrastructure development). The remaining 10 percent of financial sector assets are mostly with pension funds (6 percent) and insurance companies (3 percent); securities dealers account for only about 0.1 percent of assets.

The financial sector has suffered from the relatively recent banking crises and governance issues, but has recovered since. In May 2003, the collapse of Banco Intercontinental (Baninter) resulted in a financial crisis which subsequently led to the intervention of the third-largest bank, Banco Nacional de Crédito (Bancrédito). The assets and liabilities of these two banks were absorbed by a financial group (Grupo Leon Jiménez) and by Scotia Bank. In total, the bail-out cost about 15 percent of GDP and led to a severe contraction of the financial sector. During the crisis, three brokerage firms related to major banks had to be shut down for selling securities that were later defaulted on. In November 2005, it was found that about US\$500 million had been misappropriated at the fifth largest bank by a former president of the board of directors, raising renewed concerns about corporate governance and the quality of bank and securities market supervision. While the bank suffered some deposit withdrawals in late 2005, an announcement of a large capital injection by a new controlling shareholder stabilized the bank, and overall public confidence in the financial system was not affected.

Capital markets are underdeveloped, despite being one of the largest economies in the region. There are no equity issuers, and only 11 bond issuances from 10 companies have taken place since 2005, with an outstanding value of about US\$188 million (less than 1 percent of GDP). There is little secondary trading (since 2005, the turnover ratio has been only 22 percent). Central bank paper is the principal security traded in the country. Central bank certificates and government paper are traded in secondary markets, but outside of exchanges, mainly through banks.

The Dominican Republic has 4 specialized regulators: the *Superintendencia de Bancos*; the *Superintendencia de Valores*; the *Superintendencia de Pensiones* and the *Superintendencia de Seguros* which respectively supervise the banking sector, the securities market, the pension sector and the insurance sector.

B. The Securities Regulator

Independence, resources and powers

The Superintendencia de Valores (SIV) is an autonomous institution with independent legal standing. However, the inclusion of representatives of the central bank and the Ministry of Finance on the SIV's Board of Directors may hinder its independence. The SIV is authorized by law to impose levies on market participants to finance its activities. In addition, it receives financing from the central bank, which has been mandated by law to create a fund to supplement the resources of the Superintendency, until it becomes self sufficient. For 2006, the budget amounted to roughly US\$3.9 million, of which the majority was financed by income from the fund. While the presence of this fund puts the SIV finances on a solid footing, it has made them susceptible to changes in interest rates.

As of February 2007, the SIV has 115 personnel, making it the largest within the region. Salaries are competitive vis-à-vis the private sector, thus the SIV has not suffered from the problems of rotation that other regulators in the region have faced. In addition, it has had a steady budget to provide training to its personnel and market participants.

The SIV believes that the Securities Act of 2000 provides it with sufficient powers to regulate and supervise the capital market. However, these powers have not been fully tested due to the limited development of the market. Certain areas require reform, in particular by eliminating legal gaps in the regulation and supervision of issuances by financial institutions. For example, a vague definition of "public offering" (i.e., one that targets the general public and makes use of public media for the offering) has allowed some brokerage firms to place substantial amounts of unauthorized debt issues with retail investors, in contradiction with the spirit of the law.²⁹ Also, the law does not contain an explicit provision to allow the SIV to exchange information with foreign regulators, which could be a problem for any regional effort to integrate the markets.

Practice

The SIV is a recent creation that is making important efforts to improve enforcement and regulations. The issuance authorization process has been streamlined, although participants still perceive it to be very formalistic and lacking a business friendly approach. In the area of regulations, the SIV has enacted many of the rules necessary for the implementation of the Securities Act. However, certain key regulations, mainly for the operation of mutual funds and for the marketing of foreign securities are in the process of being drafted.

Self regulatory organizations

By law the securities exchange is a self regulatory organization under the oversight of the SIV. There is no formal agreement between the SIV and the BVRD delimitating regulatory and

²⁹ The off-shore offices and/or affiliated Group companies of both the failed Bancredito and Banco Progreso issued commercial paper through their affiliate bank to retail investors, without the authorization of the SIV nor oversight by the Superintendency of Banks (SB). They claimed these were private placements, and thus did not need to conform to the requirements of the Securities Act and SIV regulation.

supervisory responsibilities. In practice, the BVRD has had a weak regulatory role due in part to the limited development of the market.

C. Securities Intermediaries

There is a large number of intermediaries. In spite of the low number of operations in the stock exchange there are 12 brokerage houses, of which about half are associated with banks. Two new brokerages have recently been approved by the securities regulator: Citibank, and one related to a Central American bank (Lafise). Another related to a bank from Trinidad and Tobago (Bank Republic) is awaiting approval. In addition, there are seven pension fund managers and 32 insurance companies.

Table 26. Dominican Republic: Financial Intermediaries

	2003	2004	2005	2006
Number of authorized mutual fund managers	4
Number of authorized pension fund managers	7
Number of authorized investment advisors	0
Number of authorized banks	14	14	13	13
Number of authorized stock brokers	10
Number of authorized insurance companies	32
Other	0

Source: IMF/MCM survey

D. Market Infrastructure

Trading systems

Public trading systems are relatively underdeveloped. The BVRD is the only securities exchange, and by law it is a mutualized corporation. Trading systems on the BVRD are automated, but secondary market transactions are carried out on a discontinuous and order driven system. The regulatory framework requires clearance and settlement to take place in $t+1$; however brokers signaled that in practice settlement can take as long as five days because of cumbersome procedures related to the physical custody of central bank and government paper. Settlement takes place through the commercial banks rather than in accounts at the central bank. The system does not work on DvP.

Brokerage houses are allowed to trade both in the securities exchange and OTC. Currently, there is no obligation for brokerage houses to report their OTC transactions to the regulator. However, new regulations pertaining to intermediaries, effective in 2008, will require that all transactions be reported to the regulator. The SIV is designing a mechanism to disseminate this information which will facilitate price formation on the secondary market.

Depository and book-entry services

There are problems of fragmentation of depository services and physical securities. CEVALDOM, a private company, is the central securities depository. However, for central government securities, depository and payment services are provided by Banco de Reservas, a state-owned bank. In parallel, with the help of the World Bank, the central bank is in the process of creating its own depository, for transactions in its own paper. It would be optimal if different depository services consolidate, given the size of the market. In particular, to perform its function fully, CEVALDOM needs capitalization and an upgrade of its IT systems. These issues are being addressed through current negotiations between CEVALDOM, Banco de Reservas and CAVALI (a Peruvian securities depository).

The lack of mandated dematerialized securities constitutes a major inefficiency in the market. Dematerialization is voluntary, and according to AFPs, banks are not authorized to issue dematerialized securities (i.e., CDs). Some private debt issues (the latest six) have been dematerialized. However, problems persist. For example, by law pension funds must have 95 percent of their securities that are issued physically deposited at the central bank. The central bank does not have an efficient system of custodial services, so transactions are operationally somewhat cumbersome and costly.

Rating agencies

Rating agencies are subject to licensing by the SIV. There are two rating agencies that are active in the market, one local and one associated with an international agency (Fitch).

E. Investor Base

Aside from banks, there are public and private pension funds (AFPs), and a small insurance sector.

Table 27. Dominican Republic: Mutual and Pension Funds

Mutual Funds	2003	2004	2005	2006
Total number of Mutual Funds authorized for PO	0	0	0	4
Assets under Management (US\$ million)	0	0	0	0
Assets under Management (percent of GDP)	0	0	0	0
Percent of net assets invested in local equities	0	0	0	0
Percent of net assets invested in local corporate debt	0	0	0	0
Percent of net assets invested in foreign securities	0	0	0	0
Source: IMF/MCM survey				
Private Pension Funds	2003	2004	2005	2006
Number of authorized pension funds	9	8	7	7
Assets under Management (US\$ million)	34	184	368	643
Assets under Management (percent of GDP)	0.2	1.0	1.3	2.0
Percent of net assets invested in local equities	0.0	0.0	0.0	0.0
Percent of net assets invested in local corporate debt	0.0	0.0	3.2	1.9
Percent of net assets invested in foreign securities	0.0	0.0	0.0	0.0
Percent of net assets invested in financial institutions	100.0	100.0	96.8	98.0

Source: IMF/MCM survey

Pension funds

Pension funds (AFPs) are expected to be significant drivers of growth in the market, but there are important obstacles to their participation. At end 2006, they had about US\$1 billion in reserves to invest (about 3 percent of GDP), and they expect to accumulate about 0.5 percent of GDP annually. However, AFPs are currently not authorized to invest in government securities.³⁰ Recently, the President announced that he would seek approval for pension funds to invest in central bank paper, which constitute the most important tradable securities in the domestic capital market. Second, the system of pension fund regulation, following that of Chile (which

³⁰ The list of permissible investments outlined in the Social Security Law, which regulates pension funds, does not specifically mention domestic government debt as permissible. However, the law states that investments not specifically mentioned might be allowed if approved by the National Social Security Council (CNSS).

intends to shield pension investments in a developing market from undue risks), heavily restricts the private paper that AFPs can invest in by requiring that they have an investment grade (and in practice also be authorized by the Risk Rating Commission (CCR))³¹. Third, AFPs are not allowed to invest abroad.³² Thus, AFPs are left only with bank and savings institution certificates of deposit as instruments for investment. These make up about 95 percent of the value of AFP portfolios.³³

Participants agree that an important obstacle to capital market development is the additional layer of qualification requirements and the approval process of the pension fund regulator. Investments of AFPs are controlled by the Pension regulator and all instruments are vetted by the Comision Clasificadora de Riesgo (CCR). For a private issue to be eligible for AFP investment, it must be approved by the SIV and then approved *again* by the CCR. Of the 11 outstanding issues, only 4 have been approved by the CCR. This multiple approval requirement causes considerable delays and uncertainties for private issuers (2-6 months). While the pension regulator has general criteria (such as public issues meeting certain ratings) CCR's specific approval is needed for individual securities already so rated.

Mutual funds

Mutual funds are at an early stage of development. The lack of full regulations, a paucity of securities, the preference of savers for deposit-like instruments, and experience of recent crises are all contributing factors. The current legal framework also appears to have some rigidity, for example, requiring separate managers for closed- and open-ended funds.

F. Equity Markets

Key indicators

There are no equity issuers. The SIV has canvassed some 40 potential issuers of certain size and ability to issue securities, but with no success so far.

G. Disclosure and Corporate Governance Requirements

SIV disclosure and corporate governance requirements have some gaps. The main problem relates to the lack of deadlines to comply with the different disclosure obligations, including quarterly and annual financial statements, substantial holdings and material events. In addition, there is no obligation to notify and disclose insiders' holdings to the public. Minority rights are mostly limited to the framework established in the Commercial Code for all joint stock companies. To this framework the Securities Act has only added a mandatory tender offer for the

³¹ The CCR is composed of the heads of the different financial sector regulators.

³² Again, although there is no specific prohibition to investment in private equities or external international securities, these investments require the approval of the CNSS, which has not yet been forthcoming.

³³ Like in other countries in Latin America, AFPs are required to guarantee a return within a band of two percentage points relative to the industry average, which encourage funds to hold similar portfolios.

acquisition of control in a listed company, but regulations to operationalize this obligation have not been enacted. A code of corporate governance for listed companies has not been developed. There is no minimum float requirement.

Incentives for and obstacles to equity issuance

As in other Central American countries, there is a lack of investment culture. Company treasurers are focused on managing tax liabilities and do not consider accessing capital markets to manage funding needs. Pervasive family ownership and a lack of willingness to disclose financial information inhibit equity issuance to minority shareholders.

H. Corporate Bond Markets

Key indicators

The corporate bond market is small, but growing rapidly. As noted in paragraph 3, eleven bond issues from ten companies were traded in the market as of April 2007, up from zero in 2003. Half of the issuers are financial companies. The total value of outstanding private bonds is US\$187 million. There is relatively little trading on secondary markets through the securities exchange, with annual volumes of about US\$48.5 million in 2006.

Table 28. Dominican Republic: Debt Markets

	2003	2004	2005	2006
Number of companies with outstanding issues authorized for PO	0	1	4	9
of which: -financial	0	0	1	4
of which: non-financial	0	1	3	5
Number of issues to date	...	...	...	...
Total amount of outstanding debt (US\$ million)	...	1	120	187
Total amount of outstanding debt (percent of GDP)	...	0.0	0.4	0.6
Maturity: Less than a year	...	...	...	...
Maturity: Between one and five years	...	...	...	...
Maturity: More than five years	...	...	...	...
Number of companies that requested authorization for PO during year	0	1	5	10
Number of new issues authorized for PO	...	...	...	...
Value of new issues authorized for PO (US\$ million)	...	1	120	77
Number of companies that requested cancelation of registration before regulator	...	1	4	5
Number of companies that requested delisting during year	...	0	0	0
Total traded volume during year (US\$ million)	...	...	38	50
Turnover ratio (in percent) 1/	...	...	63.5	32.7

Source: IMF/MCM survey

Disclosure requirements

Listing disclosure requirements appear to be reasonable, but regulation of ongoing disclosure is weak. The SIV has not established deadlines for the presentation of the annual and quarterly financial statements nor for the disclosure of material events, which has led to low compliance. Issuers are not required to list in the securities exchange. If they decide to do so, then they have to go through a separate listing process. Currently the only requirement of the BVRD is a photocopy of the SIV file with the registration approval.

Incentives for and Obstacles to Corporate Bond Issuance and Investment

The main obstacle for the development of the corporate bond market is the difficulty of approval of the pension fund regulator. The process of approval for issuance by the SIV has been difficult in the past, but participants acknowledged that approval times have recently improved. Beyond the SIV, however, the requirement of CCR approval to be eligible for AFP investments is a critical obstacle for corporate bond issuers. As AFPs are the largest investors, such approval is critical to a private issuer's success in placement and pricing. CCR sets general criteria (such as minimum ratings) for AFP investments, but the requirement for its specific approval and the submission of additional information beyond that demanded by the SIV, are considered serious hurdles for private issuers. CCR's rejection of some of the issues already approved by the SIV also casts doubt on both SIV's approval process and ratings. The additional time it takes for SIPEN (pension regulator) and CCR approval (6-7 months) over and above the time it takes to get SIV approval, also makes the issuance process more cumbersome and costly.

The requirement of the CCR for an investment grade rating for pension fund investments is also an obstacle for the market since many firms do not have the rating. Of those that could get investment grade, they can also get prime rate financing from banks and prefer to access bank financing than to release additional information to the market.³⁴ These procedural hurdles have led to significant private placements, particularly relating to real estate development and tourism.

As in other countries, there is poor liquidity in the corporate bond market, which discourages issuance and investment. A fundamental constraint is that corporate bond issues are not standardized, which affects price formation. Furthermore, the lack of obligations on brokerage houses to report to the public all transactions carried out, including OTC transactions, has affected price transparency and price formation.

Finally, the high level of financial liquidity in the market makes funding through banks cheaper. This is linked to the issue of AFPs having relatively no other investment opportunity than in bank CDs, which has channeled the majority of savings into bank deposits.

³⁴ Recently, one small savings and loan association in which AFPs had invested was intervened, leading to the observation that AFPs invest in private banks and financial institutions that do not have ratings, but are required to invest only in highly rated corporate debt. As of January 1 2008 investment in financial institutions by AFPs will require a rating for such institutions. Most banks are rated, while most smaller financial intermediaries are not. This might have the effect of even further reducing the scope for diversification for pension fund investments.

Problems in asset-backed securities issuance

Participants feel that the current legal framework for ABS is insufficient. The Securities Act only includes a few articles related to ABS that do not deal with important issues such as bankruptcy remoteness (the need to protect assets in the special purpose vehicle (SPV) in the case of bankruptcy of the originator). The legal framework also lacks the concept of a trust. There are other more fundamental issues that inhibit ABS activity, including double taxation, and the lack of a standardized mortgage market. In terms of double taxation, the tax on the transfer of property (4.3 percent levied at each transfer point for assets) would make the operation of transfer of assets to a special purpose vehicle prohibitively costly. In addition, the financial transactions tax is imposed on every transaction along the process of securitization, which further increases the cost of the operation. The authorities have agreed that there should be special accounts for securities trading that would have different treatment with respect to the financial transaction tax, and it is hoped that this special treatment can be extended to SPVs in an asset backed securitization.

Mortgage lending has increased rapidly following a 2002 law that allowed banks to lend in this market. Mortgages are not fully standardized, and individual contracts carry each originating bank's floating rate which makes the bundling and securitization of these instruments difficult. *The Banco Nacional de Fomento a la Vivienda* (BNV) wants to take advantage of the fact that the mortgage guarantee is obligatory to create a standard contract that would facilitate securitization.³⁵ While banks are considering securitization, they are likely to move slowly given their current liquidity and capital situation. On the other hand, savings and loan associations, which account for 85 percent of mortgages, are largely mortgage oriented and have a capital shortage. Hence, they are more likely to undertake securitization in the near future. Insurance companies and pension funds provide a ready demand for mortgage backed securities (MBS). Recently, *letras hipotecarias* (bonds issued by the bank with mortgage assets as collateral) have been permitted to be issued to AFPs by the SIPEN, whose stance toward ABS/MBS issuance may be critical to the success of the market.

I. Preconditions

Company law

Legal and operational requirements related to incorporation and collateral are cumbersome, even by Central American standards. For example, there is a requirement to go to the National Intellectual Property Institute (*Oficina Nacional de Propiedad Industrial*) to obtain a certification that the name of the corporation has not been used before, as a first step in the process. Registration of pledges has to be done with a justice of the peace, which makes the process more lengthy and somewhat unpredictable due to the lack of specialization of justices in

³⁵ BNV is a second tier bank that used to supervise and regulate the mortgage market. Now it concentrates on mortgage guarantees and on mortgage origination, but it is interested in securitization. (It also has inherited some development bank functions from the central bank and channels financing to productive activities.) Virtually all mortgages are in pesos and carry floating rates with a maturity of 15 years.

this process. In addition, there could be problems with the registration of pledges over certain types of assets (for example, a floating charge over inventory). Registration of mortgages takes place at the Commercial Registry, which is a recent creation. Although enforcement of collateral has to be done via the judicial system, execution of mortgages by financial institutions is subject to a special speedier process by dispositions of the Monetary and Financial Law.

The framework for bankruptcy is outdated. The commercial code dates back to 1890; there was a reform in the 1980s to create a reorganization procedure similar to the U.S. Chapter 11. However, it has not been effective. In practice, bankruptcy proceedings are seldom used.

Financial transparency

Corporate financial transparency thresholds appear to be low. Companies with contracts over RD\$50,000 with the public sector are required to keep their financial statements according to IFRS. However, it is not clear whether groups of companies are required to consolidate their financial reporting. Companies with a paid-in capital in excess of RD\$750,000 (about US\$23,600) are required to have their financial statements audited, but there is no obligation to publish them. Companies seeking loans of RD\$5 million or more require audited accounts, according to the banking regulations.

Requirements for public accountants are low. Public accountants must obtain a license from the Ministry of Finance but, as with the rest of the region, no professional examination or practical experience is required. The *Instituto de Contadores Publicos* does not have sufficient resources to conduct oversight functions of the 3,000 registered auditors. The Securities Act does not explicitly provide the SIV with regulatory powers over auditors; however it does allow it to register “other” participants not included in the Act. As a result the SIV has created a registry for external auditors suitable for firms with securities in the market. Moreover, each Superintendent maintains registries of qualified auditors, but separately.

J. Regional Integration

The SIV supports a process of regional integration. Moreover its current framework provides for automatic authorization of public offerings for issuers registered elsewhere, although there has been no interest of issuers from other countries in Central America to use this avenue. Recently the SIV proposed the creation of a Central American Institute of Securities Markets –along the lines of the *Instituto Iberoamericano de Mercados de Capitales*, but the proposal was rejected by other countries in the region. Instead they agreed on signing a Memorandum of Understanding (MoU) in order to share information and commit to mutual cooperation and technical assistance as with the adoption of standardized processes and regulations based in international market principles. They also agreed to meet periodically and discuss integration efforts.

K. Recommendations

Regulatory capacity

The regulatory framework is in general adequate, but could be strengthened by increasing SIV independence, resolving gaps in legislation and clarifying responsibilities of the securities

exchange. The composition of the board of the SIV could be reviewed to strengthen SIV independence from the central bank, including their financing schemes. In addition, the Securities Law should be amended to resolve gaps in the regulation and supervision of issuances by financial institutions and the prosecution of unauthorized public offerings and to provide explicit powers to the SIV to exchange information with foreign regulators. In addition, the regulations for the operation of mutual funds and the marketing of foreign securities, which are in the process of being drafted, should be implemented. Finally, the SIV should sign an MoU or similar document with the securities exchange to clarify responsibilities.

Market infrastructure

A number of reforms should be undertaken to improve the liquidity and efficiency of capital markets. The first priority is to work on the dematerialization of government and central bank securities, as well as private sector securities. This would greatly facilitate trading and settlement. Second, it is necessary to adequately capitalize and upgrade the systems in CEVALDOM, and centralize in it depository and book-entry system services to increase the efficiency of the market. Third, accordingly, eliminate the requirement that AFPs must maintain 95 percent of their investment in central bank custody. Finally, implement a system for price registration and publication of all transactions, including OTC, that would provide a benchmark pricing function for the market and facilitate a more transparent price platform for secondary market trading.

Investor base

Improving regulations to enhance the investor base is key to developing the market. Important steps in this direction include enacting key regulations on mutual funds, and rules for the marketing of foreign securities, which will increase the supply and demand for securities in the market. There is also an urgent need to gradually open up the market for central government securities to the AFPs to diversify their portfolios and create a more liquid government securities market that could provide a benchmark for private securities. Liberalizing the system of pension fund regulation to allow them to invest more readily in private paper, both domestically and abroad, would be a significant step in increasing the demand for paper and liquidity in the market. In this connection, a key step is to eliminate the requirement of a separate review of each issuance by the CCR for AFP investment, replacing it with general criteria.

Equity and corporate debt markets

Improving disclosure will improve the functioning of the securities markets. In this connection, SIV should strengthen disclosure requirements for equity issuers, including the establishment of deadlines to fulfill disclosure obligations and the development of regulations that require disclosure of insiders' holdings and transactions. In addition, SIV should establish deadlines to fulfill periodic disclosure obligations by corporate debt issuers. Developing, in consultation with the industry, a code of corporate governance for listed companies would also improve the quality of issuers and securities. Finally, SIV should speed up and streamline issuance registration process.

Asset-backed securities

The essential preconditions for establishing a market for the securitization of mortgages should be put in place. This requires: improving the legal framework for ABS and resolving issues of double taxation; developing and implement standardized mortgage contracts that would facilitate securitization of these instruments; developing a common reference rate for mortgage contracts in consultation with the central bank and banking association, and a standardized mortgage instrument. There is also a need to eliminate or clarify the imposition of the 4.3 percent transfer tax at origination and transfer of assets to the SPV under a potential ABS.

Preconditions

Reforms related to preconditions to the functioning of the securities market would support the above specific market reforms. The most important reforms in this area include: simplifying conditions for incorporation of companies, in particular requirement to get first a certification from the *Registro de la Propiedad Industrial*; improving the framework for pledges and collateral; adopting a new bankruptcy law; increasing the threshold for corporate transparency and requiring consolidated financial reporting for groups of companies; and removing the tax on financial transactions for capital market transactions as it creates multiple taxation of some transactions.

Appendix 3. Country Studies: El Salvador

A. Overview of the Financial Sector

The banking sector is the dominant player in the country's capital markets. Twelve banks operated in the country at end 2006 (of which nine were owned by foreigners, controlling over 90 percent of assets, and two are state-owned) and were the main suppliers of domestic credit (around 50 percent of GDP by end-2006) (Table 29). There were 13 brokerage houses. Many of them also provide portfolio management services, an area in which they face competition from the banks.

Private securities markets are relatively underdeveloped and dominated by public debt. There is only one securities exchange, the Bolsa de Valores de El Salvador (BVES), where trading activities are concentrated in short-term repo operations of government securities and U.S. dollar-denominated debt instruments issued abroad by El Salvador and other Central American countries, Mexico, Colombia, and Brazil. As in other countries in the region, the universe of domestic investible securities is restricted. This situation is expected to worsen as some of the larger issuers are delisted following the recent purchase of domestic banks by foreign investors and the sales proceeds are expected to remain onshore. The current securities market law does not allow mutual funds to operate, though there are some small relatively unsupervised collective investment schemes (*carteras de inversion*) that invest mainly in government securities. Other financial institutions, including insurance companies and investment banks, only play a minor role in the securities market.

The current supervisory structure in El Salvador is based on specialized regulators for banks, securities markets, and pension funds. The supervisory agency for the securities market is the Superintendencia de Valores (*Supvalores*).

Table 29. El Salvador: Financial Intermediaries

	2001	2002	2003	2004	2005	2006
Number of authorized mutual fund managers 1/	8	8	9	8	8	8
Number of authorized pension fund managers	3	2	2	2	2	2
Number of authorized investment advisors	33	30	32	32	35	35
Number of authorized banks	14	13	13	14	13	12
Number of authorized stock brokers	16	16	16	16	14	13
Number of authorized insurance companies	18	20	19	18	17	17
Other	1	1	1	1	0	0

Source: IMF/MCM survey

1/ Mutual funds are not allowed by law. This refers to the collective investment schemes known as *carteras de inversión*.

B. The Securities Regulator

Independence, resources and powers

The *Supervalores* is nominally independent, but its institutional structure and funding make it subject to outside pressures. It is an independent legal entity, but the composition of its board of directors includes representatives from the central bank, which could hinder its independence. In addition, the lack of legal protection of staff against personal lawsuits may also limit their

freedom of action. Approximately 90 percent of its budget is financed by the central government and 10 percent from levies on market participants. Its budget is part of the central government budget.³⁶

The powers of the securities regulator are hindered by deficiencies in the securities law. The securities law was introduced in 1994, but it is antiquated, and needs to be thoroughly revised. Basic deficiencies include weak regulatory and supervisory powers of the regulator vis-à-vis the securities exchange, an inadequate framework for the protection of minority investors, a weak framework for the regulation of financial intermediaries (in particular capital adequacy norms) and a weak disciplinary framework for dealing with infractions. In addition, the current legal framework does not include regulations for mutual funds or asset-backed securities. While both laws have long been proposed, have significant backing from market participants, and are under study in the congress, they remain mired in the legislative process due to opposition of specific interests.

Practice

According to market participants, the authorization process is cumbersome. Different from the rest of the countries in the region, issuers have to arrange for listing with a brokerage, then list first at the BVES and finally register with the *Supervalores*. Although requirements do not differ, each entity conducts its own review and in practice the *Supervalores*, being at the end of the chain, is faced with the verification of information and enforcement of regulations. From an issuer's perspective, the process thus needs to be better coordinated. The *Supervalores* is also perceived by some market participants as being formalistic in its requirements, as having limited knowledge of the market and of a lack of consistency in the application of its policies, although it is unclear whether this is due to the issuer's desire for a more lax regulatory environment.³⁷ As a result, the authorization procedures are considered an obstacle for the expansion of the market. This is supported by a recent assisted self-assessment of the implementation of the IOSCO Principles, which shows that supervision and enforcement have been weak.

SROs

The delineation of powers between the regulator and the securities exchange needs to be made clearer. By Law, the securities exchange is a self regulated organization technically under the supervision of the *Supervalores*. However, there is not a clear division of responsibilities among the regulator and the securities exchange. In actual practice, the Bolsa existed long before the formation of the *Supervalores*, and it is widely regarded as having more influence.

³⁶ For 2006 its budget amounted to \$1.57 million. As of February 2007, the Superintendence had 45 people. A planned reform of the capital markets law would clarify the powers of the Supervisor and provide a steady and independent source of income.

³⁷ Participants provided examples of cases where the *Supervalores* had gone against its own policies, for example in the registration of Panamanian issuers under the Memorandum of Understanding (MoU) with Panama.

The main intermediaries are brokerage houses, which have declined in number from 23 in 2000 to 14 at December 2006, following liberalization of the industry. Many brokers also provide portfolio management services, and area in which they face competition from banks. Other financial institutions, including insurance companies and investment banks, only play a minor role in intermediation of private securities.

C. Market Infrastructure

Trading systems

Trading systems are relatively well developed. The BVES is the only securities exchange. It is a demutualized corporation, listed itself on the stock exchange. Its trading system is automated, the market is continuous, and order driven. Clearing and settlement takes place in $t+3$ (the repo market in $t+0$), under gross settlement on the securities side and multilateral netting on the cash side. Risks from the securities side are managed through pre-deposit of securities prior to trading, and on the cash side with pre-approved debit limits in bank accounts. Settlement does not occur in DvP. The legal framework requires secondary market transactions to be carried out on the securities exchange. Trading on the exchange is concentrated mainly in repurchase agreements involving government bonds. Trading costs in the securities exchange are roughly 28 bps.

Depository and book-entry services

Securities trading is mostly dematerialized. The Law required all fixed income securities to be dematerialized from September 2002 forward, and as of December 2006, 83 percent of fixed income securities were dematerialized. Dematerialization of equity securities is optional and equity securities are largely not dematerialized. The Central de Valores (CEDEVAL) is the central securities depository that manages the electronic-book entry system for dematerialized securities.

Rating agencies

Rating agencies are subject to licensing by the *Supervalores*. The requirements to set up a rating agency are minimal, and according to some market observers, “price competition” in the ratings industry leads to unreliable ratings. Furthermore, the authorities have, from time to time, exercised pressure on smaller credit rating agencies to clarify their assessment of companies. There are two major rating agencies in the country, including Fitch.

Price vendors

At the moment, no dedicated price vendors exist. Development of a pricing methodology is a pending issue that will become critical when *carteras de inversion* are phased out and mutual funds enter into operation. The BVES has a project and is seeking assistance from Colombia and Mexico to introduce price vendors in the market.

D. Investor Base

Mutual funds

Mutual funds are not allowed under current law, but there are other collective investment vehicles. A draft of a new mutual fund law has awaited passage for almost six years in Congress. There is, however, a relatively unregulated collective investment vehicle, *Carteras de Inversión*, managed by brokerage houses that issues quasi-deposit like liabilities backed by long-term fixed income assets, mostly domestic government bonds. The risks of these deposits are poorly disclosed and/or understood. The investment funds are not marked to market, even if underlying investments are liquid. Currently, about US\$500 million is managed through carteras de inversión down from US\$720 million in 2005. Factors cited as responsible for the decline include mounting concerns about the risks of these funds after the mutual fund crisis in Costa Rica, and the expected introduction of a new mutual fund law that may require liquidating the funds in a three-year period following the introduction of the law. As a result, brokerage houses have reduced their asset base and drained liquidity from the securities exchange.

Pension funds

Since the privatization of the social security system in 1996, the importance of pension funds in the financial system has been increasing steadily. As of end-2006, pension funds managed assets of about 19 percent of GDP. There are two large pension funds operating in El Salvador. Pension funds enjoy some investment flexibility but their portfolios are not well diversified. The law allows up to 10 percent of assets to be invested in equities, 10 percent in corporate bonds, and 20 percent in mutual funds. In practice, about 80 percent is invested in government securities, partly due to a requirement of investing a minimum of 30 percent of assets in paper issued by the Fideicomiso de Obligaciones Previsional (Certificados de Inversión Previsional—CIPS) and partly due to the lack of investible domestic securities.³⁸ Pension funds are also required to complete all their transactions in the securities exchange and through brokerage houses, which adds an additional layer of fees. Pension funds cannot participate directly in public debt auctions (which are routed through exchange brokers) and cannot invest directly in any foreign security; rather they can invest only in foreign securities or exchange traded funds on the local securities exchange.³⁹

³⁸ In September 2006, the government set up a special Pension Commitments Fund (Fideicomiso de Obligaciones Previsionales - FOP), administered by a second-tier state owned bank, to finance its remaining obligations under the old pension system before it was privatized in 1996. To capitalize this fund, the government required private pension operators (AFPs) to invest 30 percent of their assets in Certificados de Inversión Previsional (CIPS).

³⁹ There has been a change in regulations that would allow AFPs to invest in El Salvador sovereign external debt, expected to be implemented in the second half of 2007.

Table 30. El Salvador: Mutual and Pension Funds

Mutual Funds (administradoras de inversión)	2001	2002	2003	2004	2005	2006
Total number of Mutual Funds authorized for PO	...	...	...	...	...	8
Assets under Management (US\$ million)	...	...	...	...	...	...
Assets under Management (percent of GDP)	...	...	...	...	...	...
Percent of net assets invested in local equities	...	...	...	...	...	...
Percent of net assets invested in local corporate debt	...	...	...	...	...	...
Percent of net assets invested in foreign securities	...	...	...	...	...	...
Private Pension Funds	2001	2002	2003	2004	2005	2006
Number of authorized pension funds	3	2	2	2	2	2
Assets under Management (US\$ million)	790	1,099	1,599	2,224	2,949	3,495
Assets under Management (percent of GDP)	5.7	7.7	10.6	14.1	17.4	19.1
Percent of net assets invested in local equities	...	...	...	...	...	...
Percent of net assets invested in local corporate debt	...	...	...	...	...	...
Percent of net assets invested in foreign securities	...	...	...	...	...	...

Source: IMF/MCM survey

E. Equity Markets

Key indicators

The equity market is relatively large compared to others in the region. In 2006 there were 43 companies listed with a capitalization of US\$7,716 million, up from 40 companies with capitalization of US\$1,937 in 2002. Some of the equity listings correspond to privatized public enterprises, whose shares were not widely traded, and there have been major stock repurchases as the firms went private again. In addition to local firms, there are 21 U.S. firms listed locally, and exchange-traded funds (ETFs) to allow investors access to equities on U.S. exchanges. Monthly trading volume was about US\$16 million in 2006, boosted by the expected sale of banks to foreign companies.

Table 31. El Salvador: Equity Markets

	2001	2002	2003	2004	2005	2006
Number of companies with outstanding equity issues		25	25	26	28	28
of which: -financial		14	14	17	19	19
of which: non-financial		11	11	9	9	9
Number of listed companies		40	39	39	45	43
of which: -financial		28	28	30	36	34
of which: non-financial		12	11	9	9	9
Number of IPOs		0	0	0	0	0
Value of IPOs:		0	0	0	0	0
Number of companies that requested cancelation of registration before regulator	3	0	0	6	2	1
Number of companies that requested delisting during year	3	0	0	6	2	1
Equity Market capitalization (US\$ millions)		1,937	1,972	3,500	4,849	7,716
of the 5 top companies		1,377	1,386	2,220	2,891	4,460
Equity Market capitalization (percent of GDP)		13.5	13.1	22.1	28.6	42.1
of the 5 top companies		9.6	9.2	14.0	17.0	24.3
Trading volume (in US \$ million)	23	24	10	503	80	197
Turnover ratio (in percent) 1/		2.5	0.5	18.4	1.9	3.1

Source: IMF/MCM survey

Disclosure and corporate governance requirements

Ongoing disclosure requirements have some gaps. These relate mainly to the lack of timely disclosure of material events and insider and substantial holdings. In addition, insider holdings are only disclosed when they reach the threshold of a substantial holding. Minority rights are mostly limited to the framework established in the Commercial Code for all joint stock companies. A code of corporate conduct for listed companies has not been developed. Tender

offers are not mandatory for the acquisition of control in a listed company. There is no minimum float requirement.

There is a prominent role for the securities exchange in collecting and disseminating information on listed companies. Issuers have to list with the *BVES* before registering with the *Supervalores*. *BVES* requirements are essentially identical to those of the *Supervalores*, but each one conducts its own review of the information presented. In practice, the *Supervalores* usually has additional comments and can impose additional requirements if it feels this is in the interest of investors. From an issuers' perspective the dual listing and registration process is cumbersome.

Incentives for, and obstacles to, equity issuance and investment

Official requirements for listing explain the size of the market. Banks, insurance companies, pension funds, and other financial institutions are required to list on the securities exchange. However, secondary market liquidity is restricted since 1 in 5 equity securities is not yet dematerialized. According to market observers, local banks, that are required to issue shares in the securities exchange, are interested in maintaining this status quo as it enables them to easily monitor the identity of those who hold their shares.

Weak corporate governance and a predominance of family-owned businesses that do not wish to share ownership constitute major obstacles for equity issuance. The difficulty of registration of securities is also a major disincentive to participation. The listing process is hampered by a lack of coordination between the *BVES* and the *Supervalores*, a perception of inconsistent implementation of regulations, and excessive information requirements. The protracted approval process has caused some large domestic companies to circumvent local registration by seeking listing abroad and registering as foreign securities in the local market.

F. Corporate bond markets

Key indicators

The corporate debt market is smaller than the equity market. In 2006 there were 56 firms with outstanding issues of income securities, up from 44 in 2001. However, the notional outstanding amount of bonded debt fell from US\$1,996 to US\$914 million. Most corporate fixed income securities have tenors of less than five years. Turnover in the market is higher, with a ratio over 100 percent in the last four years.

Table 32. El Salvador: Debt Markets

	2001	2002	2003	2004	2005	2006
Number of companies with outstanding issues authorized for PO	44	45	47	52	54	56
of which: -financial	13	13	13	13	12	12
of which: non-financial	31	42	27	33	36	38
Number of issues to date	89	75	98	124	136	147
Total amount of outstanding debt (US\$ million)	340	363	439	865	698	823
Total amount of outstanding debt (percent of GDP)	2.5	2.5	2.9	5.5	4.1	4.4
Maturity: Less than a year	...	...	...	...	...	...
Maturity: Between one and five years	...	...	...	...	...	...
Maturity: More than five years	...	...	...	...	...	...
Number of companies that requested authorization for PO during year	3	0	0	2	5	2
Number of new issues authorized for PO	12	5	20	13	14	18
Value of new issues authorized for PO (US\$ million)	2,247	865	11,163	1,608	5,850	70,258
Number of companies that requested cancelation of registration before regulator	3	0	0	2	5	2
Number of companies that requested delisting during year	2	3	0	6	2	1
Total traded volume during year (secondary only) (US\$ million)	1,997	1,056	494	939	665	913
Turnover ratio (in percent) 1/		300.5	123.2	144.0	85.1	120.1

Source: IMF/MCM survey

Disclosure and corporate governance requirements

Disclosure requirements for the registration of corporate bond issues are in line with international standards. The one exception is the lax requirement for timely disclosure of material events. At least one credit rating is mandatory for publicly issued debt securities, and two credit ratings for the security to be purchased by pension funds.

Incentives for, and obstacles to, corporate bond issuance and investment

As for equities, the process for registration and listing of bonds is considered cumbersome. Market participants consider the legal requirements for registration and listing are reasonable, but the implementation of the law by the *Supervalores* is uneven. This perception also exists for the registration of foreign securities. Market participants consider that the superintendence has too much discretion and that its implementation of the regulations is excessively formalistic. For its part, the *Supervalores* counters that these complaints have to do with a reluctance of issuers to comply with a level of disclosure mandated in the law, and which is designed to protect local investors.

A measure affecting issuance is the treatment of reserve requirements on certain assets. Banks' certificates of deposits and mortgage-backed bonds, provided they have maturities of 5-years or more, are exempt from reserve requirements. Therefore, banks have a strong incentive to issue these securities. Currently, six domestic banks issue these securities regularly.

A significant difficulty is the lack of a benchmark sovereign yield curve for guiding the pricing of corporate fixed income instruments. As a solution, the market has turned to the average rate on certificates of deposit of public sector banks as a pricing guide. This is an imperfect benchmark, however, since the banks' borrowing cost is often below the yield on comparable maturity public debt and LIBOR. Some market participants suggest using Libor rates as a benchmark given that El Salvador is a dollarized economy.

The tax regime distorts incentives for issuance of, and investment in, bonds. Interest paid by banks to individuals is tax-exempt, but that from corporate bonds is not, which biases individuals toward holding balances in bank deposits.

The secondary market for corporate debt is limited. Corporate fixed income instruments are privately placed among the issuing company's shareholders prior to listing, and shareholders generally follow buy-and-hold investment strategies. The requirement that pension funds hold at least 30 percent of their portfolio in CIPS bonds also restricts liquidity in the fixed income market. Finally, the anticipation of a change in the legal environment to allow for the introduction of mutual funds, and a perceived requirement that all *carteras de inversion* will have to be liquidated prior to the turnover, has led to a decline in demand for fixed income instruments.

The investment rules appear biased to some market participants. The regulation does not prevent banks from investing in foreign securities directly, while other investors can only do so through the securities exchange. The fact that many of the brokerage houses are either associated or owned by banks contributes to the perception of collusion.

Problems in issuance of asset-backed securities

Currently, there is no legal framework governing the issuance of asset-backed securities. The passage of the draft law prepared by the central bank is being delayed due to tax issues. According to market participants, the law leaves open the possibility of double taxation, first at the SPV level by levying a tax on assets, and then on the transfer of assets to the SPV with a tax on asset transfers. This interpretation has been challenged by the central bank asserting that the tax on the transfer of real property would only be imposed if real property were transferred into a trust. Municipal taxes on assets of all trusts also discourage the securitization of assets.

G. Preconditions

Company law

The legal framework for business is largely adequate, except in cases where the judicial system is involved. Processes for constituting and registering companies do not present major problems. Similarly, the constitution and registration of pledges is relatively simple. Mortgage registration, however, is more complicated. As in most of the other countries in the region, execution of collateral is a major problem since it has to be done through the judicial system, which is deemed very inefficient. Guarantee trusts are not used as a substitute enforcement mechanism because the current law taxes the transfer of assets into these trusts. The bankruptcy framework is outdated and does not include the possibility of corporate workouts outside the judicial system. As a result, bankruptcy procedures are rarely used.

Financial transparency

While better than in many countries in the region, there is still a need to update financial transparency and disclosure regulations. All joint stock companies are required by law to prepare audited annual financial statements filed with the Superintendence of Corporate Obligations, an entity within the Ministry of Economy. However, this filing is confidential, defeating the goal of dissemination of company information. A copy of the balance sheet without notes has to be filed with the commercial registry. While a version of IFRS was adopted in 2004, the country is not

fully compliant with the most recent IFRS. Practicing accountants have to be affiliated with the Accounting and Oversight Board (CVCA).⁴⁰ Requirements are low since practitioners only need an academic degree and 2 years experience. In 2004 the CVCA began a pilot project of quality control.

Taxation of financial instruments

There is no tax on interest, dividends, or capital gains received by an individual. Currently, administrators of portfolios (*carteras de inversión*) are treated as natural persons, and not liable to tax. Legal persons pay a 10 percent tax on gross revenue. The proposed mutual fund law defines mutual funds as legal persons, thus creating the possibility of a mutual fund paying this 10 percent tax on its gross income. This must be eliminated to allow the industry to develop and permit a transition from the current ill-constructed investment fund framework.

H. Regional Integration

The regulator has taken some steps towards regional integration with the Panamanian market. There is a bilateral MoU between security regulators of El Salvador and Panama, under which they recognize each other's regulations and listing requirements as sufficient in principle. In practice, however, this mutual recognition has not worked well, as El Salvador has placed additional requirements on Panamanian firms wishing to list on its exchange. In addition, there has been some discussion of harmonizing regulations for market intermediaries. Panamanian brokerages want to enter the Salvadorian market, but the market remains protected. Another MoU was signed with Costa Rica, but the only commitment in this case is to engage in best efforts to streamline the authorization process.

The exchanges have also moved towards the development of a common trading platform. Separately, the securities exchanges of Costa Rica, El Salvador, and Panama also signed a MoU in September of 2006 for the development of a common trading platform that would allow intermediaries in these three countries to trade in real time in all three markets through correspondent contracts. The goal was to have these arrangements developed by March 2007. However, the project has encountered problems, and the exchanges have sought technical support from OMX (the Nordic exchange) to move forward. Practical issues of different settlement conventions (t+0 and t+1) and different trading platforms have to be overcome.

I. Recommendations

Regulatory capacity

The securities law needs to be updated to strengthen the role of the regulator. As a first step, the new framework should review the composition of the board of the *Supervalores* to strengthen its independence from the executive. In addition, a review of the law should clearly establish the superintendence as the principal regulator, with oversight over the securities exchange. The

⁴⁰ Consejo de Vigilancia de la Profesión de Contaduría Pública y de Auditoría.

superintendent should also sign a memorandum of understanding with the securities exchange to clarify responsibilities.

Market Infrastructure

While market infrastructure is relatively well developed, but efficiency could be improved. In this connection, the market should move towards full DvP (delivery versus payment) in transactions. In addition, the establishment of a price vendor and clear procedures for marking-to-market traded portfolios of banks, and all portfolios of asset managers will facilitate the development of a mutual fund industry.

Investor base

The introduction of a legal framework for mutual funds is urgently needed. Such a law should define a sunset period of three years for the current *carteras de inversión*, and should establish a moratorium on the acceptance of new money into the *carteras*. Reducing the requirement of having two ratings for private securities to be eligible for pension fund investments to one rating would increase demand for private securities.

Equity and corporate debt markets

Strengthening disclosure requirements will increase transparency in the market. For equity issuers, this would include shortening deadlines for mandatory disclosures and imposing stricter rules on disclosure of insider holdings. For corporate debt issuers, regulations should shorten deadline for disclosure of material events. Finally, in consultation with the industry, the development of a code of corporate governance based on international best practices would enhance the quality of private securities.

Facilitating issuance procedures would help increase the supply of private securities. This is particularly important given nascent stage of the market and the need to encourage new issuance. Important steps include simplifying and standardizing issuance procedures, and removing the discretionary element from new issuance approvals. In addition, coordinating registration and listing procedures would facilitate creation of new securities.

Asset-backed securities

Enacting a legal framework for ABS is a priority. The law that exists may be sufficient, as long as tax ambiguities are addressed. Streamlining mortgage registration procedures would also facilitate securitization.

Preconditions

Private securities markets would benefit from improvement in auditing disclosure, and tax law. In particular, full implementation of IFRS would improve the clarity of financial statements. In addition, making accounting with IFRS more widespread by requiring auditing and filing of financial statements by corporations that meet certain threshold would improve disclosure and remove a bias against security issuance. For the accounting industry, strengthening requirements to become an authorized public accountant as well as oversight mechanisms for auditing practice

would improve the quality of disclosure. Finally, several aspects of tax law need to be amended or clarified. For instance, mutual funds should not be subject to any tax on their income, and should be specifically exempted from tax in the organic law.

Appendix 4. Country Studies: Guatemala

A. Overview of the Financial Sector

As is common in the region, the financial sector in Guatemala is dominated by the banking system. Currently, there are 22 domestic banks and three foreign banks operating in the country; the top four banks controlled around two thirds of the assets in the banking system. There are currently three mergers ongoing, which will reduce the overall number of banks.

Both the equity and corporate debt markets are highly underdeveloped. As a result, the two securities exchanges in Guatemala mainly trade government bonds and repurchase agreements. There are several reasons for the underdevelopment of the market. Perhaps the most important is the generalized lack of confidence in the financial system prompted by a series of banking crises, failures of brokerage houses and defaults of corporate bonds by Guatemalan companies since 1999. In 1999 the country experienced the failure of three brokerage houses and four corporate issuers, including the bankruptcy of the largest coffee exporter in the country. In 2001 three banks were intervened. More recently, in 2006, the bankruptcy of Refco prompted the suspension of activities of Banco de Café, the fourth largest in the country. This, and the failure of Banco del Comercio in early-2007, brought to light troubles with offshore banks that resulted in nonpayment of some private securities the result of less-than-transparent issuance practices (where the purchaser of the security did not know that the underlying instrument is a private unregulated and risky security).

Compared to other countries in the region, securities regulation is at a very incipient stage. There is no regulatory authority which directly oversees the securities market, and one office whose function is to register publicly issued private securities. As a result, there is a heavy reliance on the securities exchanges for information gathering and analysis.

B. The Securities Regulator

Independence, resources, and powers

There is no securities regulator in Guatemala. Registration of securities and some very minimal supervision are performed by the *Registro Nacional de Valores de Mercado* (RNVM), a dependency of the Ministry of Economy with very limited funding from the central government. As of February 2007, the RNVM had a staff of five, including the Registrar.

The RNVM has not had a meaningful role in market regulation and supervision. The 1996 Ley del Mercado de Valores (securities market law) provides for a very limited role of the Registrar, with a weak definition of the supervisor and its functions that has led to inadequate powers to discipline and penalize supervised institutions. Furthermore, due to the shortage of staff and resources, the RNVM depends heavily on the institutions it supervises, the two securities exchanges, for basic information, data analysis, software and other services. In recent years, there have been efforts to pass a new securities market law, modeled on the Spanish securities market law. However, the current election cycle and a lack of consensus between political parties and the private sector have frustrated passage of this law.

Other critical legislation is also needed to further encourage the growth of the private securities market. Amendments or new legislation are needed to clarify the framework for the operation of mutual funds and pension funds, to encourage the emergence of a domestic institutional investor base. In addition, a securitization law is needed to facilitate the issuance of ABS to fill the gap created by the lack of long-term corporate bonds.

SROs

By law, securities exchanges are self regulatory organizations. There is very little oversight of the exchanges from the Registrar. The larger exchange, the Bolsa de Valores Nacional (BVN), has conducted some limited oversight of brokerage houses. Currently it has two people dedicated to this function.

C. Securities Intermediaries

Financial intermediation in Guatemala is dominated by the banking sector. Most banks operate offshore centers outside the normal regulatory environment, though financial conglomerates should comply with consolidated supervision and capital adequacy requirements. In addition to the banking sector, there were 21 finance companies that fund their operations through bond and commercial paper issued on the main securities exchange, the BVN, and provide credit at slightly lower rates than commercial banks. The number of brokerage houses has declined from 34 in 2002 to 21 in 2007.

Table 33. Guatemala: Financial Intermediaries

	2001	2002	2003	2004	2005	2006
Number of authorized mutual fund managers	...	...	...	...	...	...
Number of authorized pension fund managers	...	...	...	...	...	...
Number of authorized investment advisors	...	...	...	...	...	...
Number of authorized banks	31	31	26	25	26	23
Number of authorized stock brokers	...	34	27	23	23	21
Number of authorized insurance companies	18	18	18	18	18	18
Other						

Source: IMF/MCM survey

D. Market Infrastructure

Trading systems

Currently, there are two securities exchanges operating in Guatemala. The *Bolsa de Valores Nacional* (BVN), which is the main exchange and the *Bolsa de Productos y Mercancías* (BOLPROMER). Financial securities are mostly traded in the former, while commodities, coffee, and grain are traded in the latter, which has gradually lost importance to the BVN. As of end-2006, there were 21 brokerage houses affiliated to the BVN. Clearing and settlement can be done off exchange. In the case of the BVN clearing and settlement takes place in $t + 1$. The BVN has not established risk management mechanisms. There is no obligation to perform secondary market operations in the securities exchanges. Up to now, participation in the securities exchange has been mainly by private banks. The banks' operations are mostly confined to repurchase agreements, which account for more than 90 percent of transactions.

Depository and book-entry services

The sole depository is the central bank, but deposit is not mandatory. Among investors and market participants, there is a strong preference for holding physical certificates, a trend reinforced by the fact that dematerialization is not mandatory. This situation may have had adverse effects on the liquidity of the secondary market.

Rating agencies

Rating agencies are required to “register” at the RNVM. Currently there are 3 rating agencies registered, including Fitch, one from El Salvador and one from Costa Rica.

E. Investor Base

The investor base has been constrained by regulations. Only in 2006 were banks, insurance companies, and the social security system (Instituto Guatemalteco de Seguridad Social, IGSS) allowed to invest in private debt securities as long as the securities were rated investment grade. These institutions are not allowed to invest in equity securities.

The tax regime favors income from financial investments. Banks, insurance companies, investment societies and brokerages affiliated to banks are exempt from taxes on financial income. Nonbank affiliated brokerages must pay the tax.

Pension funds

Pension funds and the IGSS do not play a major role in the development of the private securities market. The IGSS portfolio is concentrated in public paper, while the private pension funds associated to banks are very small. As of today, the IGSS has 85 percent of its assets under management (AUM), (US\$780 million) invested in sovereign paper (of which 40 percent are in securities issued by the Ministry of Finance, and 60 percent in securities issued by the central bank). The remaining 15 percent is invested in short-term instruments issued by banks. The IGSS is considering investing in “cédulas hipotecarias,” or mortgage backed securities, but has not yet done so.

A draft pension system reform law –that would create private pension funds—is under consideration. This may have a positive effect in boosting the role of these institutional investors. However, concerns on the constitutionality of the law have to be solved first.⁴¹

Mutual funds

There are no formal mutual funds, nor a corresponding mutual fund law. Investment societies (*Sociedades de Inversión*) that take deposits for investment are authorized by the Securities Act. There are only two functioning investment societies: BAC Valores and Portafolio de Inversión.

⁴¹ The Constitution establishes the right to “social security” stating that it is a public function provided under a national, unitary a mandatory regime. As a result many participants believe that transferring the public social security system (in whole or in part) to private administrators would require an amendment to the Constitution.

The portfolios of these two institutions are invested mostly in government or central bank paper, and in U.S. dollar denominated debt issued by Central American countries. The portfolios are valued at face value since there are no mark-to-market requirements. The administrative fees are relatively low, ranging from 1 to 1½ percent.

F. Equity Markets

Key indicators

The equity market is almost nonexistent. As of December 2006, there were three companies authorized for listing, but only one company that had equity securities outstanding.

Disclosure and corporate governance requirements

Disclosure requirements are weak. There is no obligation to disclose material events, nor insider and substantial holdings. In addition, a prospectus is only required if the offering is carried out off the exchange. A code of corporate governance for listed companies has not been developed, which has dampened the development of the equity market (see below). Acquisition of a public company does not require a mandatory tender offer.

Incentives and obstacles to equity issuance

There are a number of problems restraining the emergence of an equity market. These include weak corporate governance, concerns about security and the disclosure of wealth which lead to secrecy, intolerance of minority participation, tax evasion, and the prevalent use of double books. Also, corporations have strong linkages with the banking system, which biases their funding toward bank loans rather than the issuance of securities, either equity or debt. There has historically been no secondary market trading since the shares of publicly listed companies are closely held by investors. The prior bad experiences of investors in relation to public shares issued in the process of privatization of public enterprises (before 1999) have also dampened investors' appetite for equities. Moreover, as explained above, a large segment of the investor base—insurance companies, banks, and investment societies—are not allowed to hold equities in their portfolios.

There have been a few private placements, but these are managed by banks for a limited clientele. The prospectus is distributed to a narrow range of clients. The shares are not subsequently traded, but the bank that places the shares continues to monitor the underlying company performance for the clients.

G. Corporate Bond Markets

Key indicators

The financial sector is the main issuer of fixed income corporate securities. During the past 5 years, up to 120 companies have issued short-term paper with a 3-year maturity or less, with an average maturity in the 12-18 month range. At present, the outstanding amount of fixed income corporate securities is around 1 billion Qz., corresponding to issues by 15 companies. None of these are rated, and thus do not qualify for investment by banks, insurance companies, and IGSS.

Table 34. Guatemala: Debt Markets

	2001	2002	2003	2004	2005	2006
Number of companies with outstanding issues authorized for PO		47	48	47	49	35
of which: -financial		33	32	32	33	25
of which: non-financial		14	16	15	16	10
Number of issues to date		47	48	47	49	35
Total amount of outstanding debt (US\$ million)		62	80	76	118	143
Total amount of outstanding debt (percent of GDP)	-	0.3	0.3	0.3	0.4	0.4
Maturity: Less than a year	
Maturity: Between one and five years	
Maturity: More than five years	
Number of companies that requested authorization for PO during year		3	1	3	4	2
Number of new issues authorized for PO		3	1	3	4	2
Value of new issues authorized for PO (US\$ million)		26	2	74	157	13
Number of companies that requested cancellation of registration before regulator		1	8	0	1	1
Number of companies that requested delisting during year		0	1	0	0	2
Total traded volume during year (US\$ million)		56	74	78	128	135
Turnover ratio (in percent) 1/		181.9	104.6	99.6	132.0	103.2

Source: IMF/MCM survey

Disclosure requirements

Disclosure requirements for corporate debt appear to be weak. There is no obligation to disclose material events. Unlike the majority of countries in the region, a rating is not mandatory for issuance.

Incentives and obstacles to corporate bond issuance and investment

There are a number of disincentives for private corporations to issue public debt. A grey area in the Banking Law relates to the issuance of public bonds by private issuers. The law prohibits private corporations other than financial institutions from raising funds in public markets, discouraging public issuance of corporate securities. Institutional investors (banks, insurers and the IGSS) were allowed to invest in corporate securities only in 2006, and that too is limited to investment grade rated securities. Furthermore, it appears that there is limited awareness of credit risk among investors. Indeed, the regulations do not require public bond issues to be rated, and none of the outstanding bonds in the market are rated.

Corporate security issuance also suffers from the absence of a liquid government benchmark yield curve. The establishment of such a benchmark has been impaired by the fragmentation of the government securities market caused partly by the fact that the law does not allow the central bank to issue debt but allows it to take deposits. Consequently, the central bank supplies nonstandard certificates of deposit continuously, which are not fungible with other government obligations. Nonstandardization of debt issues is a problem that also affects corporate debt.

As in other countries of the region, cheap and plentiful bank credit in a declining interest rate environment also limits interest in issuing debt securities.

The tax regime is biased against holders of private debt instruments. There is a withholding tax on interest from bonds, but not from bank loans. Moreover, the full tax is collected from the final recipient of a coupon payment, who may have held the bond for only a part of the coupon period. This reduces liquidity of bonds. Also, financial institutions (essentially banks) do not have to pay VAT, hence there is a market segmentation between banks and other investors. Loss recognition

based on mark-to-market valuation of portfolios is not recognized by the tax authorities. This situation creates incentives against trading and reduces liquidity in the secondary market, as banks, which can voluntarily mark-to-market their portfolios, choose not to so. Going forward, the situation could lead to problems if pension funds and mutual funds are requiring to mark-to-market their portfolios.

Problems in issuance of asset-backed securities

There have been a few securitizations in the market. Among recent securitization deals, a firm called Mercury securitized mortgages purchased from four banks. The transaction was based on a guarantee from OPIC of \$100 million. The underlying asset is a portfolio of mortgages in the amount of \$25 to \$50 million with 15, 20, and 30 year maturities. The first ABS issue was in November of 2006 for about \$2 million, and \$8 to \$10 million issues are in the pipeline. The increasing presence of regional and international banks could support securitization. Very recently, G&T Continental completed a securitization of remittances.

The development of the ABS market is constrained by the existing law. Despite initial attempts at securitization, the law does not provide a clear framework for establishing a special purpose vehicle (trust or corporation). Although the law does not actually prohibit the use of SPVs, the absence of a clear framework introduces unnecessary legal uncertainty and deters potential securitization initiatives.

A number of other factors work against further progress in securitization. First, debtors need to be notified via a notary public when their liabilities are sold to a SPV trust, which can discourage securitization as banks would incur additional costs and fear damaging relationships with their clients. Second, there is a 12 percent VAT on the collection of mortgage collateral, and a 3 percent stamp tax on the creation of loan, trusts, and loan sales, which discourages ABS. Third, although the pool of collateral mortgages is becoming increasingly standardized, these are still heterogeneous instruments that are difficult to package. Finally, there are no prepayment penalties. Thus, prepayment is common and debtors use it aggressively. The prepayment risk, hence, is considerable to the bank if the securitization is not completed rapidly.

There are tax incentives for banks not to securitize their mortgage portfolios. Net income to banks from guaranteed mortgages is not taxed, but could be if the income were in the hands of MBS investors. In addition, “cédulas hipotecarias” (mortgage backed securities) are not subject to capital provisioning requirements. Thus there is an incentive for banks to hold them rather than to package them for further securitization.

H. Preconditions

Company law

The process for incorporation is easy and clear. The process is usually concluded in one to two months and corporations can start operating within 2 weeks from obtaining a provisional registration.

Registration of collateral appears to be simple, but execution is problematic. Pledges over certain types of assets (for example inventory) are not subject to registration, which hinders their

efficacy vis-à-vis third parties. Although execution is done via a more expedite judicial procedure (*juicio ejecutivo*), in practice a decision can take up to 2 years. Lack of expertise of judges also makes decisions unpredictable. As a result, as in some other countries in the region, participants are bypassing judicial enforcement through the use of security trusts.

The framework for bankruptcy is inefficient and rarely used. Procedures are slow as a result of lack of specialization of judges and excessive protection of debtors. Reorganization and corporate workouts are rarely used.⁴²

Financial transparency

The framework for financial transparency needs to be improved. The Commercial Code requires Guatemalan companies to prepare their financial statements according to GAAP, but does not define them. As a result companies prepared them according to tax rules which conflict with IFRS in a number of respects. Guatemalan companies are not required to audit or publish their annual financial statements.⁴³ Practicing accountants must be affiliated with one of two professional associations, which play no role in development activities. Entry requirements are relatively low, given that neither practical experience nor a professional examination is required.

I. Regional Integration

Guatemala supports the integration of securities markets. The securities exchanges see integration as a way to diversify the investor base and the availability of securities for Guatemalan investors. In this regards, the BVN established an electronic interconnection with other Central American stock markets, the Corro Centroamericano, in the third quarter of 2005. Further integration, however, will require strengthening the regulatory and supervisory framework, which is considered among the weakest in the region.

J. Recommendations

Regulatory capacity

The establishment of a clear legal framework and a regulatory authority are basic preconditions for the development of a market. A new, revised law on capital markets should be passed as soon as possible. In addition, the law should establish a regulator with substantive independence, power, and resources to oversee the market.

Market infrastructure

A number of measures would facilitate trading in the exchanges. Both securities exchanges should develop risk management mechanisms that protect participants. In addition, the exchanges should move towards the dematerialization of securities and impose standardization of securities both for public and private debt markets.

⁴² Guatemala, FSAP, p. 21.

⁴³ Guatemala, ROSC Accounting, and Auditing, April 2006.

Investor base

The expansion of the investor base will facilitate the development of the market. Basic preconditions include introducing a mutual fund law and solving issues related to the pension fund law. In addition, regulations should expand the institutional investor investment guidelines judiciously to permit greater investment in private securities.

Equity and corporate debt markets

Both private equity and debt markets would benefit from greater transparency. In particular, improving disclosure requirements and introducing a code of corporate governance would benefit the securities market. In addition, allowing institutional investors to hold some of their portfolio in equities would help develop the equity market.

Priorities for private debt market development include: removing ambiguities in the Banking Law with respect to the issuance of private paper; encouraging the rating of private bonds to develop a culture of credit risk assessment; develop a liquid benchmark government debt market, including by standardizing public debt securities; removing unequal treatment in the tax code of income from private securities compared to other financial assets.

Asset-backed securities

A legal framework is required for ABS transactions. This could be included in the new securities market law or promoted in a separate ABS law. The law should remove the requirement of notification by notary public of creditors for the transfer of assets into an SPV. In addition, the existing tax disadvantages for ABS could be solved, and mortgage contracts standardized to facilitate securitization.

Preconditions

Essential reforms for the preconditions of market functioning include: making necessary amendments to expedite the process of execution of collateral by financial intermediaries; amending the bankruptcy framework to allow for speedier proceedings and extrajudicial workouts; requiring the filing and auditing of financial statements for companies that reach certain threshold; and strengthening requirements to become an authorized public accountant as well as oversight mechanisms for the accountancy profession.

Appendix 5. Country Studies: Honduras

A. Overview of the Financial Sector

The financial sector in Honduras is dominated by banks. There are 16 private commercial banks, including nine domestic banks and seven foreign banks. Foreign banks account for 31 percent of total bank assets. Most domestic banks are family-run and provide credit primarily to affiliated businesses and individuals. The financial system also includes one savings and loan institution, 11 insurance firms, nine finance companies, and eight brokerage houses. After the crisis in 1998/99 the financial sector was consolidated, and foreign investors entered the market, linking the banking sector with major regional banks. The banking sector is very concentrated with over 80 percent of assets in the four largest banks. Credit to the private sector has increased rapidly since 2006 as a result of a decline in interest rates in the middle of the year. Abundant liquidity in the financial system has also been helped by large inflows of remittances of over 20 percent of GDP.

Private security markets are still in the very early stages of development. There are no equity issues and only five debt issues outstanding. Government and central bank debt dominates the securities market, making up 99 percent of trading activity. Activity on the securities exchange, the Bolsa Centroamericana de Valores (BCV) has been declining constantly since the 1998/99 crisis, which saw many issuers delist and which created a crisis of confidence in private securities as a store of value. A change in regulations that allows public institutions to access the primary market for government and central bank paper directly without having to go through the BCV has resulted in a decline in volumes traded through the Bolsa. The Bolsa and brokers intermediate only 10-15 percent of the market volume (demand from private individuals and institutions, excepting banks) in primary auctions. The two main brokers are affiliated with banks and the banks have chosen to access primary markets through them, accounting for the activity on the BCV. Secondary market trading is slim and most does not go through the BCV.

Regulation of the financial sector is unified under one entity. The Comision Nacional de Banca y Seguros (CNBS) is a dependency of the Presidency of the Republic, and includes three superintendencies: insurance and pensions; banks; securities markets.

B. The Securities Regulator

Independence, resources and powers

Institutional arrangements put in jeopardy the independence of the regulator. Being a dependency of the Office of the President has allowed the CNBS to have a direct relationship with the Executive, but has also subjected it to the same regulations and limits placed on other dependencies of the Executive Power (for example limits on salaries). Independence is also affected by the fact that the period of service of the commissioners is concurrent with the presidential term, and appointment is subject to political influence. By law, up to 50 percent of the funding for the CNBS can come from the central bank (Banco Central de Honduras – BCH). Currently 43 percent of the budget comes from the BCH and the rest from fees charged to private institutions, mainly banks. The budget of the CNBS is part of the central government budget, which in practice means that it has to be approved by the Minister of Finance and the

legislative assembly. The CNBS has 40 employees, of which 7 are assigned to the securities area.

According to the CNBS the Financial Markets Law provides it with powers to regulate the securities market. However, given the lack of development of the market, the Superintendency has not had the need to use most of its powers, and therefore the actual strength of the regulatory framework remains untested.

Practice

Because of the lack of development of the market, supervision and enforcement have been limited. The registration process at the CBNS was initially extremely cumbersome, but has improved. The first issuance took more than 1 year; although the second was issued in less than six months.

There is a need to define more clearly the regulations related to more advanced private capital market products, such as mutual funds or ABS. Although both are treated in the law, provisions are not clear enough to provide legal certainty for market participants. In addition, there is no law for private pension funds. Participants felt there is a need to improve the capacity of the CNBS to deal with new products.

SROs

The law grants the securities exchanges self regulatory powers. Given the scarce supervisory resources of the BCV (one person), in practice the CNBS does not rely on it for the supervision of brokerage firms, but rather conducts its own inspections.

C. Securities Intermediaries

Honduras has a system of specialized intermediaries for the securities market. Along with the decline in activity in the BCV, the number of brokers has fallen from 18 in the late 1990s to eight today, although even the majority of these brokers is dormant. There are 8 brokers in operation, of which two are not related to banks. Those that are associated with banks are used to carry out purchases of public paper on the primary market. The decline in the number of brokers is related to the financial crisis of 1998/99, but a recent provision that allows banks to access primary auctions for government paper without having to go through brokers has also reduced the role of brokers in the market.

Table 35. Honduras: Financial Intermediaries

	2001	2002	2003	2004	2005	2006
Number of authorized investment funds	...	...	...	...	...	0
Number of authorized pension funds	...	...	...	...	...	6
Number of authorized investment advisors	...	...	...	...	...	0
Number of authorized banks	21	19	16	16	16	16
Number of authorized stock brokers	...	...	...	...	...	8
Number of authorized insurance companies	12	12	11	11	10	14
Other	...	...	...	...	...	...

Source: IMF/MCM survey

D. Market Infrastructure

Trading systems

Trading systems are primitive. The BCV is the only securities exchange. By law it is a mutualized corporation. It does not have an automated trading system. Brokerage houses “report” transactions on private securities to the BCV. Settlement and deposit of government debt securities takes place in the central bank and BCH paper is not dematerialized. Although the certificates are kept in the vault at the central bank, market participants trade fixed denomination receipts that have to be deposited in vault at the central bank. Clearance and settlement of transactions in private paper is done off the exchange directly by the brokerage houses. By law primary placement of issuances over US\$1 million has to be made through brokerage houses. Secondary trading requires mandatory participation of brokerage houses.

Depository and book-entry services

The market is moving to dematerialization although this is not required by law. The two most recent issuances have been dematerialized through a global note. In both cases the book-entry system is managed by the issuer, since there are no central securities depositories.

Rating agencies

Rating agencies are subject to licensing by the CNBS. Currently Fitch is the only rating agency registered at the CNBS—though it works from El Salvador.

E. Investor Base

The investor base is limited. There is only a small public PAYGO pension system, and a large part of its investible reserves of about US\$500 million (about 80 percent) is used to fund loans to its members. The insurance sector is small, with a total investment portfolio of about \$800 million, and about 40% of premiums go abroad to reinsurance. While the investment regime of insurance funds seems reasonable, and allows up to 25 percent investment in equities, a lack of securities forces investment primarily in sovereign papers and indirect consumer loans. There are no mutual funds.

Table 36. Honduras: Mutual and Pension Funds

Mutual Funds	2001	2002	2003	2004	2005	2006
Total number of Mutual Funds authorized for PO
Assets under Management (US\$ million)
Assets under Management (percent of GDP)
Percent of net assets invested in local equities
Percent of net assets invested in local corporate debt
Percent of net assets invested in foreign securities
Source: IMF/MCM survey						
Private Pension Funds	2001	2002	2003	2004	2005	2006
Number of authorized pension funds	5	5	5	5	6	6
Assets under Management (US\$ million)	1,727
Assets under Management (percent of GDP)	19.2
Percent of net assets invested in local equities	7.9
Percent of net assets invested in local corporate debt
Percent of net assets invested in foreign securities
Source: IMF/MCM survey						

F. Equity Markets

Key indicators

As of December 2006, there were no publicly issued equities in Honduras.

Disclosure and corporate governance requirements

Disclosure requirements have some gaps. They do not include public disclosure of insider holdings. Honduras has enacted a mandatory code of corporate governance for listed companies. The Code requires strengthening in areas such as cumulative voting; and board and committee requirements, in particular regarding the inclusion of independent members and fit and proper requirements. The Law requires a mandatory tender offer for the acquisition of control of listed companies under certain circumstances. There is no minimum float requirement.

Incentives for, and obstacles to, equity issuance and investment

The absence of an equity market has common roots in the region. A lack of investment culture, fear of disclosure, a concentrated and closely held pattern of family ownership, and small size of companies and their financing requirements all work against equity issuance. These factors are likely at best to change very slowly.

G. Corporate Bond Markets

Key indicators

Corporate bond markets are in their initial stage. There have been two issuances of bonds in recent years (one in local currency and one in US dollars). Both are bank issues of three year paper (which is a maturity that does not require the bank to place reserves at the central bank—therefore providing cheaper funding).

Table 37. Honduras: Debt Markets

	2001	2002	2003	2004	2005	2006
Number of companies with outstanding issues authorized for PO	2
of which: -financial	2
of which: non-financial	0
Number of issues to date	2
Total amount of outstanding debt (US\$ million)	3
Total amount of outstanding debt (percent of GDP)	0.0
Maturity: Less than a year
Maturity: Between one and five years	3
Maturity: More than five years
Number of companies that requested authorization for PO during year	2
Number of new issues authorized for PO	2
Value of new issues authorized for PO (US\$ million)	3
Number of companies that requested cancelation of registration before regulator
Number of companies that requested delisting during year
Total traded volume during year
Turnover ratio (in percent) 1/

Source: IMF/MCM survey

Disclosure requirements

CNBS requirements appear to be reasonable. As in other countries in the region one rating is required. Mandatory listing at the securities exchange is required by law. The BCV has not added substantive requirements to those imposed by the CNBS; but does conduct a separate review of the same information sent to the CNBS.

Incentives for, and obstacles to, corporate bond issuance and investment

As in the case of equity, fundamental structural issues restrict bond issuance. These include: a level of discomfort with disclosure; the lack of a standardized and liquid government bond market benchmark; the lack of a large investor base; and, a strong bank based financing culture. Bank financing has also been favored by high liquidity and falling interest rates. Both corporate bond issues mentioned above were designed to access cheaper financing at longer maturities before interest rates fell rapidly in 2006. In the case of the bond in lempiras, as soon as interest rates fell issuance stopped, with only a fraction of the authorized issuance completed. In the case of the US dollar bond, the process continues. The lack of standardization and dematerialization of debt securities restricts secondary market trading and liquidity. Participants have been very critical of the registration and listing processes, which is a function of the newness of the market and the relative lack of experience of the regulator.

A key benefit for issuance is limited to banks. There is an incentive for banks to issue bonds of three years or longer, since financing received through this method is exempt from reserve requirements and therefore less costly than other traditional sources of funds.

Problems in issuance of asset-backed securities

Although the law contains one article on ABS, the legal framework needs to be improved. Market participants believe that the legal framework should be more detailed to provide stronger support to the regulations issued by the CNBS. The limitation that only banks can be trustees of

assets needs to be removed.⁴⁴ A number of large banks have expressed interest in ABS but have not moved forward because of a lack of a clear legal framework, the current excess liquidity, and a shortage of assets that can be pooled. The existence of surrender requirements for foreign exchange may also constitute a barrier to the development of ABS related to flows of export receipts or remittances.

The structure of the mortgage market does not present major impediments to ABS. Mortgages are generally standardized, and are offered in both lempiras and US dollars, at variable rates, making it relatively easy to securitize seasoned mortgages.

H. Preconditions

Company law

There are no major problems for the registration and incorporation of companies in the corporate registry. In a recent reform, the function of registering corporations has been outsourced to the local Chamber of Commerce, greatly simplifying the process.

There are no major problems for the constitution and registration of movable collateral, but mortgage registration needs improvement. Movable collateral (pledges) are also included in the corporate registry. However the registration of mortgages continues to be cumbersome, since it takes place at a separate registry (Registro de la Propiedad) which is still managed by the Instituto de la Propiedad. A recent amendment to the Notary Law (Ley del Notariado) allows for the execution of a mortgage directly by a notary through a very expedited process (within three days of notice to the borrower). However, these provisions have not yet been extensively tested. In the meantime, the current legal framework also allows for the direct sale of collateral by a notary public upon authorization by a judge. In practice, this process ends up being extremely cumbersome. Due to these problems guarantee trusts have become the norm. Bankruptcy laws are outdated. Creditors avoid using bankruptcy procedures, and prefer to execute any guarantees on assets.

Financial transparency

Financial reporting standards require updating. According to the current framework, companies have to keep their financial statements based on local GAAP. However, a new law will require the application of IFRS by companies as well as the fiscal authorities and IAS by auditors from January 2008. Requirements for external auditors appear to be low since only an academic degree is required. The CNBS has issued special regulations for accounting and auditing of the financial sector, including the creation of a registry of external auditors.

Taxation of financial instruments

The tax structure is straightforward and nondiscriminatory toward securities instruments. All income from securities pays a 10 percent tax (including capital gains and dividends). Interest on

⁴⁴ There is the possibility to establish special purpose vehicles to act as trustees, but as mentioned above, the law is not considered sufficiently detailed to give security to this kind of operation.

government paper is not exempted and the BCH retains 10 percent at the point of paying interest on its securities.

I. Regional Integration

Honduras will support a process for regional integration at the highest level. On February 14, 2007 the Presidency organized a seminar focusing on regional integration and opportunities for the Honduran market. However, at the present level of activity in the market, and for the near term, Honduras does not have adequate volume of transactions to support a securities exchange. This is partly due to the loss of volume of transactions from banks and the regulations that have allowed transactions of government debt securities to take place outside the Bolsa. In addition, larger companies have not found it advantageous to issue debt in the Honduran market and issuance has been limited to banks. A gradual process of regional integration might be one way of reviving the market by allowing access to investment in private securities from the Central American region on the local exchange, as well as the ability to list Honduran firm's securities on other exchanges.

J. Recommendations

Regulatory capacity

There is a need to strengthen the CNBS and to improve the legal framework. The independence of the CNBS could be improved by delinking periods of commissioners with presidential periods, and making the organization an independent agency, not part of the executive. In this way, the CNBS could have its own employment regulations and salaries. With respect to the legal framework, developing laws and regulations to treat advanced products such as mutual funds, private pension funds and ABS would remove a constraint from development of the market. It would be necessary to increase capacity of CNBS employees commensurately to regulate advanced products. To clarify responsibilities, the CNBS should also sign a MoU or similar document with the Bolsa to clarify responsibilities.

Market infrastructure

The standardization and dematerialization of securities is an important priority. To this effect, the CNBS should ban issuance of nonstandard corporate debt. To facilitate this, issuance of government debt should also be standardized, and the existing stock converted into standard debt. Along these same lines, the CNBS should prohibit future issuance of physical securities in the private sector and work to convert existing physical securities to a dematerialized form.

Equity and corporate debt markets

General prerequisites for the development of these markets include: strengthening disclosure requirements for equity issuances and the code of corporate governance; and streamlining registration and listing procedures. Strengthening the legal framework for ABS would also provide more securities in the market, which would benefit an expanding institutional investor base.

Preconditions

Steps to improve the preconditions for development of private securities markets include: enacting a new bankruptcy framework; and strengthening requirements for public accountants as well as oversight.

Appendix 6. Country Studies: Nicaragua

A. Overview of the Financial Sector

Financial intermediation in Nicaragua is dominated by the banking sector. There is one securities exchange, with no stocks and few corporate bonds. The main instruments traded in the market are government securities issued to compensate landowners for confiscation in the 1980s, or *bonos de pago por indemnización* (BPIs), and to restructure the banking sector, or *Certificados Negociables de Inversión* (CNIs). Domestic bonds are denominated either in U.S. dollars or Nicaraguan cordobas, though most bonds denominated in local currency are exchange-rate linked.

Nicaragua has a unified regulator. The *Superintendencia de Bancos y Otras Instituciones Financieras* oversees four *intendencias*: banks and other financial institutions; securities markets; insurance companies; and, bonded warehouses (*almacenes de depositos*).

B. The Securities Regulator

Independence, resources, and powers

The Superintendency is an autonomous entity with legal independence, but may be subject to political influence. In particular, the inclusion on the board of the President of the Central bank, as well as weak legal protection of staff and weak judicial institutions, could hinder its independence.

The Superintendency has an independent budget. 25 percent of expenses are funded by the central bank and the other seventy-five by levies on market participants. Since capital markets are underdeveloped, regulation of this sector is cross-subsidized by the fees paid by banks. The Intendencia de Valores is directly in charge of regulating and supervising the capital market. The staff in charge of market and securities supervision is seven.

The new securities law (Nueva Ley de Mercados de Valores), passed on December 2006, provides the necessary powers to regulate and supervise the market. However, given the novelty of the law these powers have not yet been tested. There could be problems with the disciplinary framework, since the definition of minor offenses is too broad and therefore subject to interpretation, which could potentially impair the role of the supervisor. In addition supervisors do not have legal protection against lawsuits incurred while fulfilling their supervisory duty.

The Securities Act, substantially modeled on the Costa Rican Law, improves on the previous law in a number of areas: (i) introducing the legal concepts of mutual funds, securitization, and credit rating agency; (ii) allowing the dematerialization of securities; (iii) allowing the listing of foreign securities in the securities exchange; and (iv) enabling the securities exchange to be a self-regulatory organization.

Practice

The regulations needed to implement the new law remain to be drafted and/or approved. While the Superintendency has developed a schedule for implementing regulations, it recognizes its

limited in-house capacity and experience to draft the regulations, especially for the new products such as securitization. Despite a lack of regulations, the Superintendency has conducted supervisory activities over brokerage houses and the securities exchange, including on site inspections. The results of inspections, however, are not presented in a consolidated report but separately for each institution that comprises a financial conglomerate. Enforcement actions have been taken against brokerage houses and banks.

SROs

The New Securities Law has given securities exchanges the nature of self regulatory organization, which was not previously the case. The Bolsa will shortly submit the proposal for self-regulation, although it is reluctant to assume an SRO role given its cost and the small volume of transactions in the exchange.

C. Securities Intermediaries

Despite high brokerage fees, the extremely thin trading and poor future prospects has caused brokerage houses to decline from 15 to 6. Five of the existing brokerages belongs to financial conglomerates. Limited activity in the securities exchange has prompted them to diversify activities into asset and wealth management, and the provision of investment advisory services. Even so, brokers express concern about the survival of the exchange and business, given the low volume of trading.

Table 38. Nicaragua: Financial Intermediaries

	2001	2002	2003	2004	2005	2006
Number of authorized mutual fund managers
Number of authorized pension fund managers
Number of authorized investment advisors	55
Number of authorized banks	10	7
Number of authorized stock brokers	6
Number of authorized insurance companies	...	5	4	4	5	5
Other	8

Source: IMF/MCM survey

D. Market Infrastructure

Trading systems

The Bolsa de Valores de Nicaragua (BVN), which is demutualized, is the only securities exchange. It has an automated trading system. Secondary market transactions are performed under a discontinuous, order driven system. By law secondary market transactions, including repo, have to take place through brokerage houses. Contrary to most markets in the regions, most of the repo transactions are performed through short-term European options on government securities. The standard repo operation requires provisioning capital against the contingent liability created by the obligation to repurchase the security. Capital provisions, currently at 15 percent, have ranged between 19 to 25 percent.

Transaction costs in the securities exchange are high at 2.5 percent of the notional amount of the transaction. One percent is paid to each brokerage house involved in the transaction and 0.5 percent to the securities exchange.

Depository and book-entry services

Only about 10 percent of the public debt is dematerialized. However, the government has a project for conversion. In addition a reform to the new Securities Law now requires dematerialization for trading in the stock exchange, and establishes a deadline of one year for the conversion of current physical securities that are being traded in the stock exchange into dematerialized securities. The Central de Valores is the central securities depository.

Rating agencies

Under the new Securities Law, rating agencies are subject to licensing by the Superintendency. However currently there are no rating agencies registered in Nicaragua.

E. Investor Base

The investor base is dominated by commercial banks. These banks invest mainly in government securities, since they face restrictions for investing in private sector securities (see below). Government securities are actively traded in the repo market, where other investors include no financial private corporations, individual investors, and state enterprises.

Insurance companies

Insurance companies are also active in the local market. However, their assets under management are very small relative to those in the banking system. As most insurance companies cede the bulk of their exposure to reinsurers, there is little demand for local securities as insurance companies technical reserves are small. Life insurance is not a major line of business, which contributes to the sector's lack of appetite for bonds. Other investors include high net worth individuals that are the main target of private placements.

Pension funds

There are no private pension funds and the public social security system remains a pay-as-you-go system. The reform of the social security system has been halted by the high transition costs of the migration toward a self-funded pension fund system. The Instituto Nacional de Seguridad Social (INSS) has reserves of about 6 billion Cordobas, mostly invested in certificates of deposit and public sector paper at maturities of less than one year.

Mutual funds

There are no mutual funds.

F. Equity Markets

Key Indicators

As of April 2007, there was no equity issuers registered.

Disclosure and Corporate Governance Requirements

Disclosure requirements established by the Superintendency appear to be reasonable; except that insiders' holdings are not required to be disclosed. The securities market law does not include specific provisions for protecting minority shareholders to complement those of the commercial code. A code of corporate governance has not been developed. There is no minimum float requirement.

Incentives for and obstacles to equity issuance and investment

As in the rest of the region, there is a structural bias against equity financing. The majority of corporations are family-owned businesses, averse to disclosing information to outsiders. Both market participants and public sector officials believe that the development of the equity market may take many years. Rather, they suggest efforts should be focused on developing a corporate bond market.

The tax system discourages investments in private securities. Securities market transactions are exonerated from transaction-specific taxes but capital gains and dividends are taxed as income. Double taxation exists, since corporations are taxed on their earnings (or profits) prior to the distribution of dividends. More importantly, banks cannot invest in securities issued by private sector firms, either debt or equity, draining liquidity from both primary and secondary markets. Finally, it is widely considered that the securities exchange has neglected promoting and educating the public and firms about the merits of listing and issuing securities in the exchange.

G. Corporate Bond Markets

Key indicators

The corporate bond market has been shrinking. The number of companies with outstanding issues has fallen from nine in 2001 to six in 2006. Over the same period, the total amount of outstanding debt has fallen from US\$ 51 million (1.2 percent of GDP) to US\$ 21 million (0.4 percent of GDP). Trading in the secondary market is low with an annual volume of about US\$ 6 million, or 24 percent of outstanding volume.

Table 39. Nicaragua: Debt Markets

	2001	2002	2003	2004	2005	2006
Number of companies with outstanding issues authorized for PO	9	9	7	6	6	6
of which: -financial	3	3	2	1	1	1
of which: non-financial	6	6	5	5	5	5
Number of issues to date	11	13	7	6	6	6
Total amount of outstanding debt (US\$ million)	51	50	38	35	27	21
Total amount of outstanding debt (percent of GDP)	1.2	1.2	0.9	0.8	0.6	0.4
Maturity: Less than a year						
Maturity: Between one and five years	30	25	21	8	6	2
Maturity: More than five years						4
Number of companies that requested authorization for PO during year	1	2	1	0	2	1
Number of new issues authorized for PO	1	2	1	0	2	1
Value of new issues authorized for PO (US\$ million)	1	3	5	-	2	10
Number of companies that requested cancelation of registration before regulator	0	0	0	0	0	2
Number of companies that requested delisting during year	0	0	0	0	0	2
Total traded volume during year	21	13	18	7	6	6
Turnover ratio (in percent) 1/	43.8	25.7	40.9	20.2	20.3	23.9

Source: IMF/MCM survey

Disclosure requirements

The Superintendencies disclosure requirements appear to be reasonable. As in other countries in the region, the new law requires one credit rating for each bond issue. However regulations do not require it to be updated periodically. In addition, currently no rating agency has requested licensing. Listing is mandatory, but the securities exchange has not established significant additional requirements to those of the Superintendency.

Incentives for corporate bond issuance and investment

Cheap bank financing has been a major factor leading to the delisting of a number of fixed income securities by non-financial corporations. Despite cheap access to bank funding, however, some corporations continue to list in the market as they consider it an inexpensive way to keep other financing options open and an effective way to signal they are more transparent and have better corporate governance than their peers. Nevertheless, in the prevailing low rate environment, the transaction fees in the securities exchange are deemed expensive by market participants. In consequence, trading in the secondary market has declined substantially. For fixed income securities, the securities exchange has proposed setting the transaction fees at 10 percent of the coupon rate or yield of the security transacted. The fees would be divided as follows: 40 percent to each brokerage house involved in the transaction, and 10 percent to the securities exchange.

The lack of a disclosure culture is a major obstacle for the development of the market. Preparing a company to go to the exchange can take a long time (6-8 months), since many companies do not have their financial information in order. Even within registered companies, there is a lack of willingness to comply with disclosure obligations; some companies have delisted rather than comply with disclosure.

There is no active secondary market for corporate debt. Debt issues have already been “pre-placed” prior to the issue with investors that are already shareholders in the company. The rates are higher than bank rates, as they are used to reward investors for lending money to the company. The higher rates, however, may hurt shareholders that chose not to buy the debt issue.

The lack of development of the sovereign local–currency bond market is an impediment to private issuance. The absence of a regular issuance calendar and lack of fungibility across different government bond issues, which are issued in non-standard denominations and maturities and have not been dematerialized, has hampered the development of a sovereign Cordoba-denominated benchmark yield curve. It is expected that dematerialization could provide incentives for further trading in government securities. The absence of a benchmark yield curve and the lack of familiarity with the use of credit ratings and the pricing of credit risk act as barriers to the emergence of a corporate bond market. Some incentives to use the market may be artificial. Repos conducted in the exchange are not subject to legal reserve requirements (currently at 19-25 percent).

Problems in issuance of asset-backed securities

There is substantial interest among banks in issuing ABS. Most mortgages are in US dollars and typically with a maturity of 15-20 years. Hence, banks are keen to secure long term funding through mortgage backed securities. There is also interest in securitizing auto loan receivables. The dominance of international banks in Nicaragua now means that banks are also more interested in their ROE rather than in size.

The lack of regulations guiding the implementation of the law is a major impediment to the development of an ABS market. Also, the *fideicomiso* or trust figure is not captured in the law. The introduction of real estate investment trusts and MBS securities could also be hampered by the obsolescence of the property registrar, where most records are processed manually. Recording a property requires three to four months in the corresponding municipality, and verifying the property record is a lengthy and costly process.

H. Preconditions

Company law

Although procedures could be streamlined, participants believe there are no major problems with the constitution and registration of companies. Requirements for the constitution of certain specific type of collateral (mainly mortgage collateral and pledges over cars) are very simple and affordable; however the registration process at the Public Registry is time consuming.⁴⁵ Other types of security mechanisms, such as leasing contracts, guarantee trusts and retention of title are non existent. Execution of collateral has to be done through the judicial process, which is lengthy and unpredictable. There is a special separate procedure for execution of collateral by banks; however the lack of independence of the judiciary was cited as a critical problem. Bankruptcy laws are outdated, thus creditor rarely use them. Again the lack of independence of the judiciary was cited as a key problem.

⁴⁵ Nicaragua FSAP, Technical Note on creditors' rights, February 2005.

Financial transparency

Financial transparency norms are below international standards. Companies are required to keep their financial statements according to local GAAP; but they are not required to audit nor publish them. Audited financial statements are not required for publicly issued debt or bank loans. As a rule of thumb, lenders suggest debtors submit audited financial statements when loans exceed \$1 million, and require them only for loans that exceed \$1.5 million. Auditors are required to get a license from the *Ministerio de Educacion Publica* and affiliation to the *Colegio de Contadores Publicos* is mandatory. Affiliation requirements include only the academic degree and 2 years of experience.

Taxation of financial instruments

There are some anomalies in tax treatment which deter investment in private securities. Natural persons are exempt from taxes on interest from publicly issued private fixed income instruments with a maturity of three years or more. Capital gains are taxed at the prevailing income tax rate. Interest from saving deposits is tax-exempt as long as the total amount in different accounts corresponding to one individual does not exceed \$5000. Interest from government securities is tax-exempt. Thus corporate bonds with a maturity of under three years are tax-disadvantaged relative to other fixed income securities.

I. Regional Integration

There is broad support for regional market integration among market participants and national authorities. The development of private securities markets has lagged behind the development in neighboring countries, especially in El Salvador, Panama, and Costa Rica. Given the extremely small size of the economy, and the relatively small size of most businesses, Nicaragua faces particularly daunting problems in reaching a viable size of the market which can support a national securities exchange, broker community and costs of securities market regulation and supervision. Brokers are under pressure and might have to consolidate even further. Hence, integration with the larger capital markets in the region might facilitate the development of the market. However, there is wide recognition that domestic standards need to be made compatible with regional norms for integration to be successful. As Nicaragua has to develop a substantial amount of such regulation from scratch, it also has an opportunity to adopt as much as possible from existing regulations, rather than develop new regulation.

J. Recommendations

Regulatory capacity

A number of important reforms would improve the functioning and independence of the regulator. The institutional arrangements for naming the board of the regulator could be reformed to provide more independence from the central bank and the ministry of finance. It will also be important to provide supervisors with legal protection against lawsuits incurred while fulfilling their supervisory role, and clarify the definition of minor offenses. Developing and implementing regulations related to the new securities market law will also be important to clarify the powers of the regulator.

Investor base

Expanding the investor base will require: developing regulations for mutual and private pension funds; and broadening the investor base by relaxing the investment restrictions in privately issued securities faced by banks.

Equity and corporate bond markets

Improved regulations for disclosure will improve the functioning of the market. In this respect, regulations should require insiders holdings disclosure for equity issuers. In addition, corporates should work to develop a code of corporate governance. For bond markets, the government should continue to develop a benchmark government yield curve by: (a) allowing the dematerialization of securities to increase the fungibility of government securities; (b) facilitating repo operations; and (c) following a regular issuance calendar. In terms of asset-backed securities, a priority for reform is to enact regulations for the implementation of the new securities law.

Preconditions

Improving the preconditions for private capital markets would include: streamlining the registration of collateral; enacting a modern bankruptcy law; consider requiring filing and auditing of financial statements of corporation that meet certain threshold size; strengthening requirements to become a public accountant as well as oversight over the profession; removing double taxation on capital gains and dividends, especially given the large tax incentives for banks and sovereign issuances.

Appendix 7. Country Studies: Panama

A. Overview of the Financial Sector

Panama is an important off shore financial and business center. The domestic financial sector is dominated by banks. Recent mergers and acquisitions have increased the role of international conglomerates. Domestic capital markets are comparable in terms of market capitalization to countries of similar size. Twenty-eight equity issuers and 52 corporate debt issuers are authorized for public offering. Trading in the secondary market is very limited. There have been a few securitization issuances, mostly of mortgages and by one entity, La Hipotecaria. On the demand side, the mutual fund industry is starting to develop with 14 mutual funds in operation and US\$ 488 million in assets under management (AUM). Private pensions funds are also underdeveloped with only US\$ 77 million in AUM. By regional standards the insurance industry is more developed with US\$ 500 million in premiums.

Financial regulators are specialized. The *Superintendencia de Bancos*, the *Comision Nacional de Valores* (CNV), and the *Superintendencia de Seguros y Reaseguros* respectively supervise the banking sector, the securities sector including pension funds and the insurance sector.

B. The Securities Regulator

Independence, resources, and powers

Although autonomous, in practice the CNV's independence has been weakened by the legal arrangements related to its budget and personnel. One of the three commissioner's positions has been vacant since end 2004,. Approximately 60 percent of the CNV expenses are covered by fees levied on market participants, while the remaining 40 percent is covered by the central government. The CNV budget is part of the central government budget which in practice means that the CNV must follow certain policies of the central government related to the number and remuneration of staff. This in turn has affected its ability to hire qualified personnel.⁴⁶ Moreover the selection and appointment of personnel requires prior approval of the Minister of Economy. For 2006 its budget amounted to US\$1.6 million. As of February, the CNV had 42 people, which has been insufficient for effective supervision of the market, as found in the IOSCO Assessment.

⁴⁷

⁴⁶ The request to hire more technical staff made in the 2008 budget has received no positive response by the authorities.

⁴⁷ The Vicepresident Commissioner resigned on June 29, 2007, and the CNV has not been able to appoint a replacement, meaning that it is operating with only one commissioner. The law requires three. The head of markets division also resigned and the CNV has hired a replacement, however he has not been able to take his position due to administrative procedures at the central government and pending authorizations by third parties that are not contemplated in the law.

The Ley del Mercado de Valores (LMV) provides the CNV sufficient powers to regulate and supervise the market. Nevertheless, there are deficiencies in specific areas: (i) the CNV does not have explicit power over external auditors, (ii) powers over rating agencies are limited since the CNV can only register them; (iii) the CNV does not have power to share non public information with foreign regulators; and (iv) the disciplinary framework could be strengthened by providing a clearer definition of misconducts and sanctions. A 2002 decision of the Supreme Court has led to uncertainty regarding the actual scope of regulatory powers. Finally, legal protection of personnel is insufficient.

Practice

The CNV has issued most necessary regulations for the implementation of the LMV, including for equity and corporate debt, mutual funds and pension funds. There are no regulations for asset backed securities, but neither the CNV nor market participants believe that the lack of a regulatory framework has hindered ABS issuances. Participants believe most of the regulations are reasonable; although there is a complaint that the CNV intervenes excessively in the definitions of acceptable investments for mutual funds. In addition, participants have complained about an overly strict schedule of penalties. The CNV has established a consultation processes for the development of regulations; however there is not a mechanism for regular dialogue with the industry.

Market participants stress that the CNV needs to streamline authorization procedures. The CNV has established a deadline of one month for the authorization process. However, participants indicate that authorization focuses excessively on formal requirements and less on material issues. Authorization for mutual funds was cited as a case where the process at the CNV has been particularly cumbersome. The CNV has stressed that insufficient human resources have hindered its effectiveness in supervision and enforcement.

SROs

There is no formal memorandum of understanding delimitating the responsibilities of the CNV vis-à-vis the Bolsa de Valores de Panama (BVP). The Bolsa has focused on the business side. Thus, up to now most of the supervision of market trading and brokerage houses has been done by the CNV.

C. Securities intermediaries

Most of the specialized intermediaries (including brokerage houses, investment advisers, mutual fund and pension fund managers and insurance companies) are bank subsidiaries. Banks work under a universal banking model and the only investment service that they cannot provide is trading in the securities exchange. As of 2006 there were 87 banks. Of the 34 brokerage houses, 7 are banks, 16 are bank subsidiaries and 11 are independent. There were 12 investment adviser licenses, out of which two are bank subsidiaries. As for collective investment managers, there were 12 mutual funds and two pension funds. There are 10 pending requests for new licenses, five for brokerage houses, two for investment managers and three for investment advisors; in most of the cases the shareholders include foreign investors. The main sources of income are asset management and trading in foreign securities.

D. Market infrastructure

Trading systems

The BVP is the only securities exchange. It is a demutualized corporation listed itself. Its shareholders include the main local banks, commercial firms, insurance companies and brokerage houses. Members already include two Colombian brokerage houses.

The BVP has an automated trading system. The market is continuous and order driven. Clearance and settlement is done with the participation of Latin Clear and Banco Nacional de Panama, a state-owned bank. Settlement occurs in $t + 3$, under gross settlement for the securities leg and multilateral netting for the cash leg. Risks in the securities side are managed through pre-deposit of securities in Latin Clear. Risks on the cash side are managed through a preapproved debit limit that participants have to maintain with a settlement bank. Latin Clear is authorized to credit and debit the members' account in the settlement bank. There is no obligation to conduct secondary trading of equity or corporate debt in the securities exchange, but there are reporting requirements for brokerage houses.

Depository and book-entry services

In practice most securities are dematerialized through a global note, although dematerialization is not mandatory, nor irreversible. The BVP requires immobilization of securities at Latin Clear for trading purposes. Latin Clear is the central securities depository as well as the manager of the book-entry system for dematerialized securities. It is a joint stock company owned mainly by the brokerage houses and the banks. Its structure allows for foreign participants—a Costa Rican bank is already a member. Currently its capital is US\$ 1 million, low by foreign investors' standards and possibly a limitation for its use as central securities depository. Latin Clear has sub custody agreements with CEVAL (Costa Rica) and CEDEVAL (El Salvador).

Rating agencies

Rating agencies are required to register with the CNV. However this is a limited process that does not provide the CNV with the authority to impose requirements nor to conduct any type of oversight activity over rating agencies. There are 5 rating agencies including one associated with Fitch.

Price vendors

In Panama, the BVP is working with Balmer a Mexican price vendor to implement a methodology for price valuation.

E. Investor Base

Mutual funds

The mutual fund industry is just starting to develop. As of June 30, 2007 there were 23 mutual funds registered, but only 14 in operation, with assets under management of US\$ 488 million. There are no real estate funds; however Costa Rican fund managers are interested in marketing

their real estate funds in Panama, as well as including Panamanian properties in their Costa Rican funds.

Pension funds

Panama provides pensions under a compulsory social-security system. A portion of the public social security system (*Sistema de ahorro y capitalización de pensiones de los servidores públicos* –SIACAP) has been given in administration to private fund managers. Investment regulations allow them to invest abroad, but securities must be rated investment grade. There are also voluntary pension funds (*fondos complementarios*), but their size is not significant. As of 2006 there were 2 private voluntary pension funds with AUM of US\$ 77 million.

Insurance companies

The private insurance business is more developed than in the rest of the region. Premium flows in 2006 amounted to US \$500 million. Investment regulations allow insurance companies to invest 25 percent of their reserves in foreign securities, provided that they have investment grade. The local portion is invested 75 percent in banks (50 percent deposits and 50 percent short term paper) and 25 percent in equity. The international portion is invested in government bonds and with investment grade corporates.

F. Equity Markets

Key indicators

Although the largest in the region, the equity market is contracting. There were 28 companies listed in 2001, but this number has fallen to 24 in 2006, of which 18 are financial intermediaries, mainly banks. The decline is due to the delisting of companies acquired by international conglomerates during the last 5 years, including the latest case: Banco del Istmo. In 2006, market capitalization was US\$ 6,819 million, 40 percent of GDP. The market is very concentrated, with the top five companies making up 80 percent of the market. Trading volume is very limited though it has grown from US\$ 45 million in 2001 to US\$149 million in 2006.

Disclosure and corporate governance requirements

Disclosure requirements are somewhat weaker than international standards. This is particularly true of timely disclosure of insider and substantial holdings. The CNV has developed a corporate governance code under a comply or explain regime. However, certain areas such as the independence of directors and constitution of supporting committees could be strengthened. The system does require a tender offer for the acquisition of control of a listed company under certain circumstances. There is no minimum float requirement.

Listing at the securities exchange is not mandatory, but most issuers choose to do so due to the fiscal incentives. Issuers need to complete the registration processes with the CNV and the BVP. In practice, they begin the registration process at the CNV and almost simultaneously initiate listing process at the BVP. The BVP does not impose additional substantive requirements to those of the CNV, but it does conduct a similar review to that of the CNV in regard to information requirements.

Incentives for, and obstacles to, equity issuance, and investment

Panama shares many of the obstacles to the development of equity markets in the region.

Much of the Panamanian economy is service oriented, and large investment projects are few. The limited number of listed companies is a result of multiple causes, many of them shared by the region. Family-owned companies still prevail and with them an aversion to give up control. An unwillingness to comply with disclosure requirements, coupled with the excess liquidity of the banking sector, encourage many companies to use bank funding instead of the securities market. There are also “scale” problems as public issuance involves minimum costs that are not worth it for companies below certain size.

G. Corporate Bond Markets

Key indicators

In contrast to the equity market, the debt market has been expanding over time. The number of corporate debt issuers has increased from 32 in 2001 to 52 in 2006, of which 29 are financial institutions. The number of new issuances authorized per year has grown steadily from 8 in 2001 to 22 in 2006, and for the same period the total value of issuances has increased from US\$ 99 million to US\$ 835 million. Trading is mostly carried out outside the exchange.

The asset-backed securitization market has also been active. There have been 12 securitizations, 11 related to mortgage securitization, of which eight were carried out by La Hipotecaria, a specialized lending company focused on housing for lower income families. While certain qualifying low income housing loans are subsidized by the government, mortgage lending is on a commercial basis. The first seven issuances of ABS were placed in the local market and the last one was registered locally and a tranche was sold in the United States to qualified institutional investors. The expansion of the Panama Canal could boost the asset backed securities market, if the authorities choose to raise funds via the capital markets.

Disclosure requirements

Disclosure requirements are reasonable. However, different from the rest of the region, Panama does not require rating. Thus only approximately 15 percent of outstanding issues are rated. Implementation of Basel II, expected by 2008, might change this situation since the banking supervisor has requested that all banks get a rating.

Incentives for and obstacles to corporate debt issuance and investment

Some of the disincentives to funding through equities also apply to debt. Disclosure requirements and the current environment of excess liquidity in the banking sector cause companies to prefer bank borrowing. In fact, interest rates have declined and the spread vis-à-vis government debt has narrowed. Good companies can get financing at rates below LIBOR and, increasingly the large companies have access to international finance. The CVN has developed a shelf registration process for commercial paper. However, participants continue to believe the CNV is rather formalistic in its review of authorization documents.

Tax treatment of interest earned on a listed security has been an incentive for certain corporations to issue bonds. In practice, banks buy the whole issuance and the interest earned is exempt from any tax, as opposed to the interest from bank loans that are subject to income tax and other additional taxes.

Problems in issuance of Asset-Backed Securities

There are no major problems in the legal or regulatory framework. Although the LMV devotes only one article to asset-backed securities and the CNV has not issued supplementary regulations, market participants believe that this article coupled with the legislation pertaining to trusts has been sufficient.

H. Preconditions

Company law

The legal environment for business is in general benign, but the judicial system is an obstacle. Panama has significantly improved the legal and registration requirements to form a corporation. In addition, the execution of movable collateral is done in an efficient manner outside the judicial system. However, execution of mortgages continues to be a problem since it has to be done via the judiciary and proceedings are considered to be lengthy. In addition, the framework for bankruptcy is outdated and thus is not used in practice: creditors prefer to have a lien on specific assets and in case of trouble execute the guarantee. There is a bankruptcy law in congress since 2002.

Financial transparency

Regulations require the use of IFRS but compliance in practice appears to be low. Tax authorities require companies with capital over \$100,000 or annual sales over \$50,000 to have audited financial statements. However, this information is not public. As with other Central American countries, requirements for auditors are low since they do not include professional examination. More recently the *Junta Técnica de Contabilidad* instituted the obligation of continuous learning for auditors. However, the Supreme Court declared it unconstitutional. In general oversight is limited. The CNV has not established a separate registry for external auditors. Moreover the LMV did not provide the CNV with explicit powers to regulate the auditing profession. While in the past they have sanctioned two auditing firms, one of the cases was challenged in the courts.

Taxation of financial instruments

The tax framework is beneficial to public securities, and additionally for those that are listed. Interest from non registered (i.e., non public) securities is subject to the tax rate of the holder. In contrast, income from registered but non listed securities is subject to income tax of 5 percent. Income from listed securities is exempted from capital gains taxes, and taxes on interest.

I. Regional Integration

The CNV strongly supports regional integration efforts. It has unilaterally given the status of recognized jurisdiction to El Salvador and Costa Rica for the purpose of equity and corporate debt, meaning that firms approved to issue securities in these countries are automatically authorized to issue in Panama. In addition it is currently reviewing extension of similar recognition to Colombia and Ecuador. In this regard, the CNV's lack of authority to share information with foreign regulators is a constraint. The BVP is also looking to develop a routing system with South American countries. Local intermediaries would route client orders to buy and sell securities whose primary listing is in another exchange to the primary exchange receiving a fee for the routing.

J. Recommendations

Regulatory capacity

Regulatory capacity could be improved by ensuring greater independence of the regulator and strengthening its powers. In particular, the CNV would benefit from greater financial and administrative independence by removing its budget from that of the central government and freeing its operations from central government's policies on number and salary of staff. The regulatory powers of the CNV could be improved by: (i) providing it with regulatory and supervisory powers over external auditors and rating agencies; (ii) strengthening the disciplinary and enforcement framework; (iii) providing it with powers to exchange nonpublic information with foreign regulators; and (iv) strengthening legal protection of CNV board and staff. Appointing the third commissioner, absent since 2004, would also improve the operations of the CNV.

Regulatory practice could also be improved with greater communication between the regulator and other actors in the market. For example, it would be beneficial to establish a mechanism to discuss common specific issues and problems with industry. In addition, following a number of adverse rulings from the Supreme Court, there is a case for further discussions within the judicial system on the scope of regulatory authority for the CNV. Finally, it would be beneficial to clarify division of responsibilities of the CNV vis-à-vis the BVP via a MoU or similar document.

Market infrastructure

The BVP and market participants should consider raising capitalization of Latin Clear.

Investor base

To broaden the investor base, the CNV should review mutual fund regulations to reduce/eliminate substantive restrictions on investment policies.

Equity and corporate debt markets

As in other countries in the region, a fundamental precondition for development of private equity and debt markets is the improvement of disclosure and governance. In this respect, the CNV should consider strengthening disclosure requirements for equity issuers, particularly timely

disclosure of insider and substantial holdings, and further improving corporate governance with additional disclosure of the level of compliance with the code.

Removing obstacles to registration and authorization of securities would also help market development. In particular, authorities should consider streamlining the authorization process, including more focus on material issues, and greater coordination with the securities exchange on requirements for listing. Authorities should also consider expanding the shelf registration process to include private bonds.

Preconditions

In terms of preconditions for the development of private capital markets, some priorities for reform include: improvements to transparency of the corporate sector, by requiring auditing and filing of financial statements of companies that reach certain threshold; allowing expedited proceedings for execution of collateral by financial institutions; a new bankruptcy law; strengthening requirements for public accountants as well as oversight mechanisms for the accountancy profession; linking substantial tax benefits for listed companies to some free float requirement.

References

Brenner, P. (ed.), 2006, *Central America: Structural Foundations for Regional Financial Integration*, (Washington: International Monetary Fund).

Diamond, D., (1984), “Financial Intermediation and Delegated Monitoring,” *Review of Economic Studies*, Vol. 51, pp. 393–414.

Myers, S.C., (1984), “The Capital Structure Puzzle,” *Journal of Finance*, Vol. 39, pp. 575–592.

Shah, H., A. Jobst, L. Valderrama-Ferrando, and I. Guerra, 2007, “Public Debt Markets in Central America, Panama, and the Dominican Republic,” IMF Working Paper 07/147 (Washington: International Monetary Fund). Available via the Internet:
<http://www.imf.org/external/pubs/cat/longres.cfm?sk=21046.0>

Tafaris, E. and R. Peterson, 2007, “A Blueprint for Cross Border Access to US Investors: A New National Framework,” *Harvard International Law Journal*, Vol. 4