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Turkey
Corporate Bond Market Development

Priorities and Challenges

February 15, 2012

Private and Financial Sector Development
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Document of the World Bank

ACRONYMS

BAT	Banks Association of Turkey
BIS	Bank for International Settlement
BITT	Banking and Insurance Transaction Tax
BNDES	Brazilian Development Bank
BNM	Bank Negara Malaysia
BRSA	Banking Regulation and Supervision Authority
CBRT	Central Bank of the Republic of Turkey
CMB	Capital Markets Board
CML	Capital Markets Law
CRA	Central Registry Agency
CVM	Securities Commission
DRC	Debt and Risk Management Committee
EPF	Employee Provident Fund
ETP	Electronic Trading Platform
EU	European Union
FX	Foreign Exchange
GDP	Gross Domestic Product
GDS	Government Debt Securities
IFRS	International Financial Reporting Standards
IFC	International Finance Corporation
IFC-Istanbul	Istanbul International Financial Center
IGE	Istanbul Gold Exchange
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
ISCAP	Institutional Securities Custodian Program
ISE	Istanbul Stock Exchange
MARC	Malaysian Rating Corporation Berhad
MGS	Malaysian Government Securities
MoF	Republic of Turkey Ministry of Finance
NBFI	Non Bank Financial Institutions
OTC	Over-the-Counter
PDS	Primary Dealership System
RAM	Rating Agency Malaysia Berhad
SC	Securities Commission Malaysia
SMEs	Small and medium enterprises
SPO	State Planning Organization
Takasbank	ISE Settlement and Custody Bank
TL	Turkish Lira
TSPAKB	The Association of Capital Market Intermediary Institutions of Turkey
TKYD	Turkish Institutional Investment Managers' Association
TurkDex	Turkish Derivatives Exchange
UT	Undersecretariat of Treasury

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Corporate Bond Market Development--Priorities and challenges

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EXECUTIVE SUMMARY

1. **Since 2001, the Government of Turkey has carried out major macroeconomic and financial market reforms, laying the ground for a vibrant Corporate Bond market.** The Turkish Lira has become more stable, with domestic interest rates steadily declining. In addition the basic regulatory and market infrastructure is robust. The Government Bond market is well functioning and recently Turkey has also become an attractive destination for international fund managers seeking emerging market debt instruments. The investment climate is further strengthened by an open exchange and capital markets regimes. Foreign investment in government securities has also facilitated the development of the domestic bond market. Given that the sovereign debt market is successful, and since a number of Turkish corporate are highly rated, the key elements for a successful corporate market are in place.

2. **Nonetheless, Turkey's financial system remains dominated by banks, posing significant financing risks for Turkey's corporate sector.** At the end of 2010**,** there were 49 banks and 375 non-bank financial institutions, but banks accounted for 88 percent of financial system assets and the corporate bond market accounted for less than 1 percent. The corporate sector in Turkey is subject to multiple risks that include currency risks, maturity risks and interest rate risks. The overall leverage ratio of the corporate sector is in line with other major emerging market countries. Banking sector loans at the end of May 2011 were TL571.3 billion, of which 31 percent were FX loans. With respect to non-financial sector companies in June 2010 the net FX position was negative US$86.4 billion. A well functioning corporate bond market could help mitigate liquidity, forex and maturity risks emanating from the reliance on bank financing. A deep and liquid bond market provides an alternative to bank credit, and thus helps to create a more competitive financial sector and to lower the cost of borrowing. An efficient corporate bond market will have bonds that have longer maturities than local bank loans, thus reducing the need for offshore borrowing and mitigating associated maturity and currency risk. In addition to meeting the financing needs of the corporate sector, the corporate bond market needs to be developed to act as a "spare tire" during a potential banking crisis.

3. **Despite rapid growth since 2002, the development of the domestic bond market faces several challenges.** The bond market, especially the government bond market, has grown rapidly with the Government's strategic decision to replace foreign currency debt with domestic currency bonds. At the end of September 2010 Turkey's local currency bond market (government and private sector) was US$238.55 billion. It was the 14th largest in the world when measured as a percentage of GDP. Although Turkey accounts for only 0.35 percent of the world local currency bond market in 2010, it was the sixth largest emerging local currency bond market in terms of size. The Turkish bond market is surpassed by only China, Brazil, South Korea, India and Mexico. However, the domestic bond market is dominated by government issues while the corporate bond market remains underdeveloped. To develop the corporate bond market several key challenges stand out. Principle amongst them are need for a broad investor base to boost demand; lack of a sufficiently large stock of longer dated government bonds to build a meaningful benchmark yield curve for pricing of corporate bonds; and an effective mechanism to handle creditors' rights and bankruptcy proceedings to reassure investors.

4. **The total investor base in Turkey is small given the scale of the economy.** At the end of 2010, the total investor base[1] of Turkey amounted to TL61 billion, or 5.48 percent of GDP. Mutual fund companies are the largest component when measured as a percentage of GDP (2.6 percent), followed by insurance companies (1.8 percent) and private pension funds (1.6 percent). Although the size of the investor base in Turkey is much smaller than the average in middle-income countries, especially East Asian countries,[2] the potential for growth is good given Turkey's demographic (young population) profile. Thus far, non-bank financial institutions (NBFIs) have played a limited role in Turkish financial markets. Their growth has been stunted by macroeconomic instability in the past and the dominance of the banking system. The NBFI industry is fragmented creating high transaction costs of between 3 to 4 percent of the value of assets under management, thereby depressing returns and discouraging private savings. Institutional investors have played a major role in facilitating the development of bond markets in East Asian countries. There is a clear need to increase the role of the NBFIs in Turkey's financial markets to create an alternative funding source for the Government and the corporate sector. Parallel reforms are needed in the NBFI sector to ensure it plays a key developmental role in Turkey.

5. **There are signs that initial reforms are paying off as the corporate bond market has seen a recent surge.** Since 2010, the corporate bond market has flourished with a number of larger blue chip issuers coming to the market. At end 2009 the Corporate bond market was TL481 million, this jumped to TL1.4 billion an end 2010 and to TL4.3 billion in 2011. Initial government measures have contributed importantly to these encouraging developments, such as the issuing of guidelines by BRSA for banks to issue local currency bonds, the leveling of tax rates on capital gains from secondary market trading between corporate bonds and government securities and for allowing shelf offerings.

6. **How can the authorities build on these early successes to further develop the corporate bond market in Turkey?** This report seeks to provide a roadmap for the type of reforms that are necessary for the Turkish corporate bond market to be a viable source of funding and investments. In this regard, key areas that are important for reforms include:

A. Increase in overall savings of the country;
B. Supply side issues: Issuers;
C. Demand side issues: Investor Base;
D. Meaningful benchmark sovereign yield curve;
E. Capital markets intermediaries issues: investment banks and brokerage firms;
F. Widen range of risk management products: futures and options;
G. Credit rating issues;
H. Enabling regulatory Frameworks, including resolving taxation issues;
I. Market infrastructure: trading platform, clearing, settlement and custody; and
J. Modernize the Capital Markets Law to enable innovation and product development.

[1] With respect to the corporate bond market, the investor base is considered as one constituting the Insurance, Mutual Fund and the Pension Fund industry

[2] Size of institutional investors in major emerging market countries (South Korea, Brazil, Chile, Malaysia, Thailand and South Africa) ranges from 40 percent to over 100 percent of GDP.

7. **Given the complexity of the issues and multiple players involved in tackling the above issues, high level of coordination is needed to implement such an ambitious roadmap.** Joint efforts are needed by the various arms of Government (Corporate Bond Market (CMB), Bank Regulations and Supervisory Authority (BRSA), Under-secretariat Treasury (UT), Central Bank of the Republic of Turkey (CBRT)) and key market participants (issuers, investors, intermediaries, rating companies, accountants). A high-level bond market committee could be set up to provide policy direction and review implementation progress. Based on the experience of East Asian countries, a five year time horizon for implementing such a roadmap would seem appropriate. Under the *Istanbul as a Financial Project* there is space to work on this concretely.

8. **The development of a Corporate Bond Market is part of a broader agenda of financial sector development**. The World Bank Group aims to work with the Government of Turkey in the long run to further deepen the financial sector, with the corporate bond markets as one of the many pillars. The policy recommendations listed below can be seen as a sequence of steps that would help Turkey realize the growth potential of its corporate bond market. It is worth noting that a number of steps discussed during the preparation of this report have already been taken and have contributed to a many-fold increase in market size over the past two years.

Results framework action plan – Corporate Bond Market Development

Challenges	Near Term (2011 -2012)
Lack of critical mass for high quality issuers of corporate bonds	▪ Build a critical mass of high quality or "blue chip" companies to issue bonds in the domestic market to diversify their funding base. ▪ Invite multilateral development banks to issue bonds in **TL (Turkish Lira)** in local market to broaden the range of high quality products in the corporate bond market. ▪ Urge Istanbul Stock Exchange (ISE) and the CMB to amend listing criteria to encourage large blue chip companies to list their bonds on the ISE by providing some form of incentives such as a faster turnaround time for issuance clearance. ▪ Disclose the financial statements of pension funds on a mark-to-market basis.
No market-making for corporate bonds	▪ Facilitate primary dealers to undertake market making for corporate bonds and amend ISE rules to create a market making system for corporate bonds. ▪ Allow T+2 settlement for corporate bonds in order to facilitate foreign investors.
Develop hedging market	▪ Allow highly rated corporate bonds to be accepted as collateral for margin under the rules of the ISE. ▪ Develop the exchange traded derivative markets to reduce systemic risk and improve competition by easing entry and exit.

Enhance trading of benchmark bonds for major tenures	▪ Introduce buy-back and conversion operations in a cost-efficient manner to enlarge the issuance size of benchmark bonds. ▪ Increase further the portion of fixed rate bonds in the debt stock to reduce vulnerability to global and domestic shocks.
Broaden investor base with variety of risk and duration preference	▪ Ensure that the benchmark 10 year Government Bonds are fully priced by the private sector participants. ▪ Introduce mandatory rating for corporate bonds.
Investor protection in case of insolvency	▪ Make clear the ranking of bond holders as compared to other classes of creditors in the event of insolvency of an issuer.
Distortion in the financial markets created by taxation	▪ Reduce capital gains tax on mutual fund trading in order to align with retail investor and create a level playing field.
Investment-saving gap as the availability of domestic savings has not been adequate to meet the funding requirement of corporate sector	▪ Re-examine the private pension space in order to enable growth and competition. The World Bank is working with the authorities in this regard.
Challenges	**Long Term (2013-2018)**
Piece-meal and prescriptive approach to regulation	▪ Enact a comprehensive and modern framework for Capital Markets Law so that it would position the Turkish capital markets to facilitate market development and innovations without compromising on investor confidence and market integrity.

CHAPTER 1

Introduction

9. **The study is in response to a request by the Capital Markets Board of Turkey to assist them in developing the corporate bond market in line with best practices globally.** During the course of the study the CMB was deeply involved with the team and contributed to the analytical work. A workshop was held in Istanbul in April 2011[3] to discuss the study's main findings, with a wide range of market and government stakeholders to include global expertise. The study is also in response to the "Strategy and Action Plan for Istanbul International Financial Center." The Government of Turkey has included this plan in the 2009-2011 medium term development program and accorded it top priority. Amongst other things, the action plan calls for the diversification of the financial sector, improvements in the legal, supervisory and regulatory structure, and simplifying and making effective the tax system. This study aims to focus on elements that are critical for corporate bond market development and the team is of the view that a dynamic corporate bond market in Turkey will allow Istanbul to become an International Finance Center.

10. **The need for a well-diversified financial market, that can meet the demand of savers and investors in a cost effective way, is well appreciated by the Turkish authorities.** The dominance of the commercial banking system, and absence of a vibrant corporate bond market, was identified by the World Bank back in 2003 in a study "Turkey Non-Bank Financial Institutions and Capital Markets Report (Report Number 25467-TU)".[4] The study covered a broad range of issues, including a regulatory framework for capital markets; savings mobilization; government bond market and the role of NBFIs (insurance and pension) and corporate bond market. Since 2003, the Government of Turkey has implemented a number of recommendations suggested in the report to set the foundation for a diversified and resilient financial system. A private pension system was launched in 2003; the Capital Markets Board has been strengthened; and market infrastructures for capital markets are now well developed. The Istanbul Stock Exchange is one of the most active emerging market stocks and TURKDEX, the derivative exchange, started its operations in 2005.

11. **Nonetheless, there are major challenges to the development of a corporate bond market.** This is due to absence of several factors such as possible perception of crowding out by the public sector; dominance of the banking system in the financial market; lack of highly liquid sovereign yield curve beyond 22 months yield curve and a small investor base. Since 2003, Turkey has made remarkable progress in improving its macroeconomic condition and building a liquid and efficient government bond market. However, the alternative source of investment funding for the corporate sector remains very limited, and the corporate sector has substantial net

[3] Proceedings of the workshop can be viewed at www.worldbank.org/tr.

[4] The study was led by Lalit Raina (FSD/PSD Program Team Leader for Turkey/Lead Financial Sector Specialist, ECSPF) and other team members comprised Marie-Renée Bakker (Task Team Leader for the NBFI/Capital Markets Study for Turkey/Lead Financial Sector Specialist, ECSPF).

exposure to foreign currency. The corporate sector is also exposed to rollover risks due to maturity mismatch. The need to increase alternative sources of long-term finance for the private sector is appreciated by both the Government of Turkey and the World Bank Group.

12. **The objective of this study is to carry out an assessment of the status of the corporate bond market in Turkey**. The study identifies key impediments and solutions to sustainable development, and it presents a roadmap to address the key impediments to the development of a dynamic and robust corporate bond market. This study provides a comprehensive review of the Turkish corporate bond market: Chapter 2 provides an overview of the Turkish economy and financial sector; Chapter 3 discusses key impediments to the vibrant development of the corporate bond; Chapter 4 looks at the Turkish bond market within global bond markets and gives a review of the Turkish government bond market; Chapter 5 discusses issues relating to the investor base, factors constraining the growth of a broad and diversified investor base are highlighted; Chapter 6 provides an overview of derivatives market in Turkey and discusses its important role in enhancing liquidity in the secondary markets for government and corporate bonds. The study concludes with a recommended roadmap to develop the corporate bond market in Chapter 7. The Annexes cover the latest corporate bond offerings in Turkey and examine the expected transaction costs. Survey details of the survey are also in the annex, and details on selected emerging market corporate bond markets and market issues relating to the legal, regulatory and tax frameworks for the bond market.

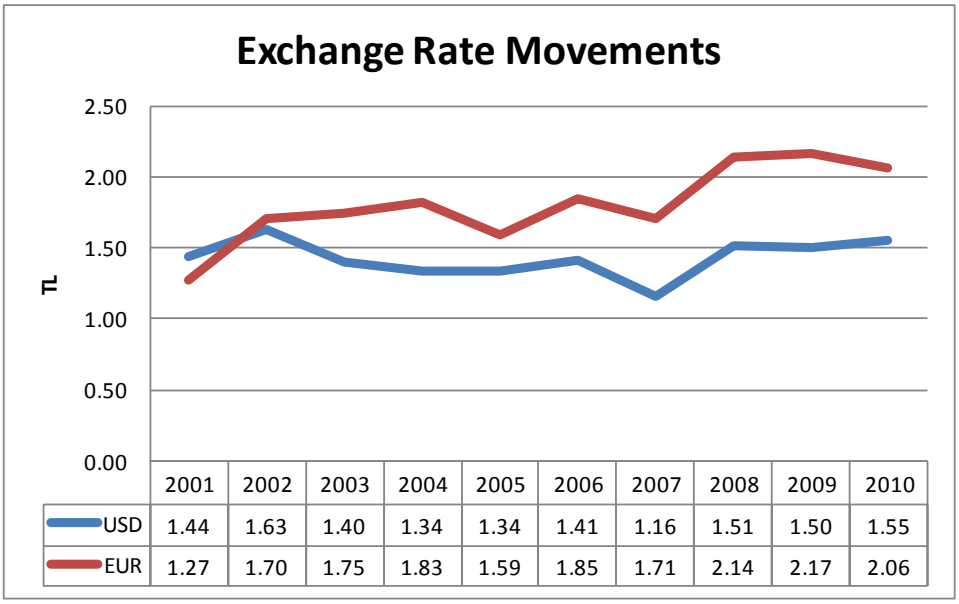
CHAPTER 2

The Turkish Economy and Financial Sector

13. **With a nominal GDP of US$735 billion and per capita income of US$10,100 in 2010, Turkey is the 17th largest economy in the world**. The Turkish economy has performed very well since 2002, following the major reforms of the economy, banking sector and improvement in public debt management. Turkey's financial strength is evidenced by the fact that the banking system withstood the 2008 financial crisis well and has been resilient, reaping the fruits of early reforms. The GDP has grown at a fast pace, averaging 7.2 percent in 2002-2006 and 2.4 percent in the global crisis period of 2007-2010, with estimates for 2011 at around 8 percent. The banking sector is well-managed, and it is one of the highest capitalized banking systems in the world. The level of public sector gross debt (EU defined, percentage of GDP) has declined from 74 percent in 2002 to 42.2 percent in 2010. As a result, the Turkish economy was able to weather the global financial crisis of 2008 relatively well, and the recovery is underway. There was no single bank closure in Turkey during the recent crisis.

14. **Turkey had a long experience with a high inflation rate.** However, the major reforms carried out by the Government of Turkey since 2002 and responsible fiscal management have had great success in breaking the inflationary spiral and expectations. Inflation has been brought under control. However, due to the tax hikes and increases in administered prices as well as increases in food prices and pass-through from exchange-rate depreciation 2011 year end inflation came in at 10.45 percent, overshooting the target of 5.5 percent for the first time since 2008.

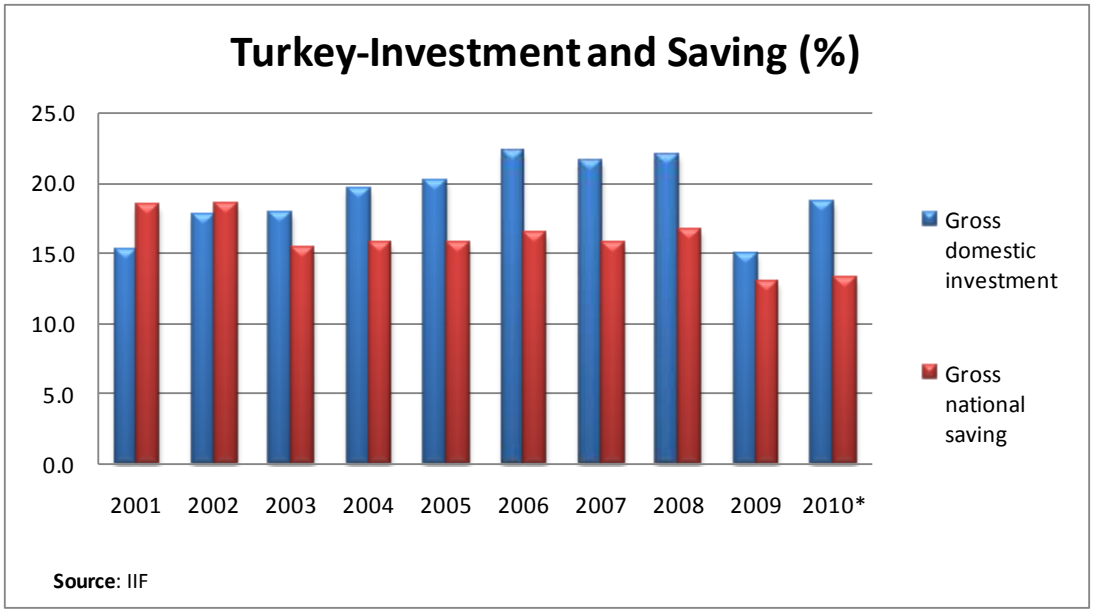
Figure 2.1: Exchange Rate Movements



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
USD	1.44	1.63	1.40	1.34	1.34	1.41	1.16	1.51	1.50	1.55
EUR	1.27	1.70	1.75	1.83	1.59	1.85	1.71	2.14	2.17	2.06

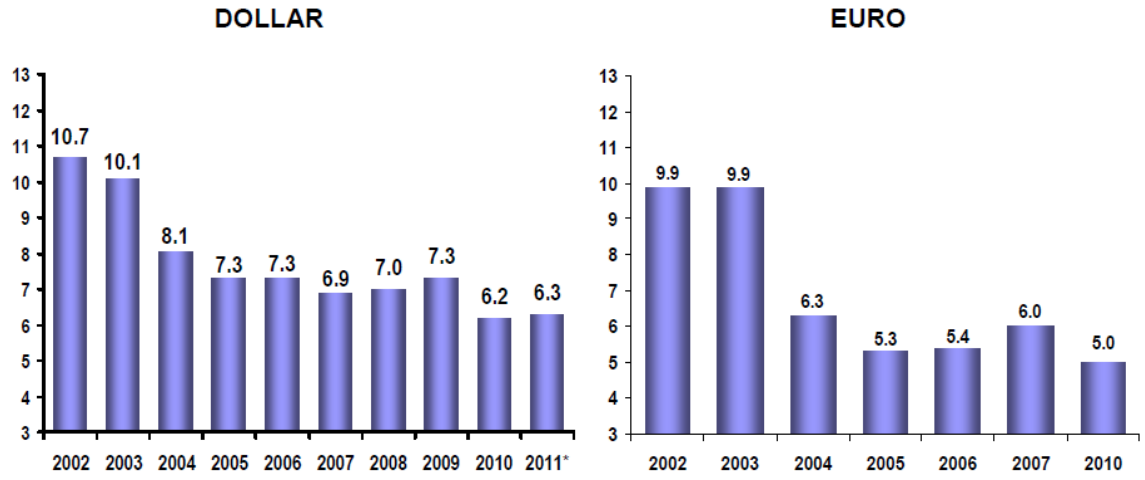
15. **There has been a notable increase in gross domestic investment**. Domestic investment, as a percentage of GDP, rose from 15.5 percent in 2001 to over 22.4 percent in 2006; however, it dropped to 20.2 percent in 2010. The savings rate in Turkey has declined steadily from 18.6 percent in 2002 to a low of 13.9 percent in 2010 (Figure 2.2). The investment-savings gap has been largely financed by external borrowing by the corporate sector. This in turn has increased the vulnerability of the corporate sector to a sharp movement in currency and international interest rates. Therefore, there is a clear need to take measures to increase long-term savings and a diversified investor base to achieve stable growth.

Figure 2.2: Turkey-Investment and Saving (2002 – 2010)



16. **Turkey's real sector economy was very much impacted by the global financial crisis of 2008-2009 following the bankruptcy of Lehman Brothers**. Turkey suffered from a short but sharp fall in GDP (4.8 percent) in 2009 reflecting a strong deterioration of investor and consumer confidence and a drop in external demand and capital inflows. The current account deficit narrowed significantly as imports reacted strongly to the sharp slow-down in domestic demand while exports were less affected. The authorities moved quickly to maintain confidence and liquidity in the banking sector (including through a reduction in reserve requirements and the reintroduction of a "blind-broker" lending facility), and implemented a set of employment measures, as well as fiscal stimuli. Between October 2008 and November 2009, the overnight interest rate was cut by a cumulative 10.25 percentage points. As a result of these measures the banking sector performed well during the crisis, and the corporate sector was able to rollover its international debt. The general government fiscal deficit increased sharply from 1.6 percent in 2008 to 5.5 percent of GDP in 2009, due mainly to the operation of automatic stabilizers (such as the increase of approximately 1.8 percentage points of GDP in budgetary transfer to the Social Security Institution (SSI)). Facilitated by expansionary policies, unemployment peaked by mid-2009 – at around 16 percent - and output began to recover by the last quarter of 2009.

Figure 2.3: Turkey- Cost of External Borrowing (%)



(*) As of May 27, 2011
Source: Undersecretariat of Treasury

The Turkish Financial Markets

Overview

17. **The Turkish financial markets have experienced a dramatic growth following the major economic reforms of 2002**. The total size of the financial markets has increased more than threefold, from TL310.1 billion at the end of 2002 to TL1,007 billion by the end of 2010. Figure 2.4 provides an overview of the Turkish financial markets from 2002 to end March 2010. A unique feature of the Turkish financial markets is the dominance of the banking system. It accounted for 86.5 percent of the financial markets at end 2010, as compared to the NBFI sector, which accounted for 12.1 percent at the same period. The stock market in Turkey has grown rapidly since 2005, and market capitalization has increased 803 percent from 2002 to 2010. Nonetheless, the stock market has thus far not been a major source of funds for the corporate sector. A comprehensive breakdown of the Turkish financial system is shown in Table 2.1.

Figure 2.4: Turkey-Financial Markets

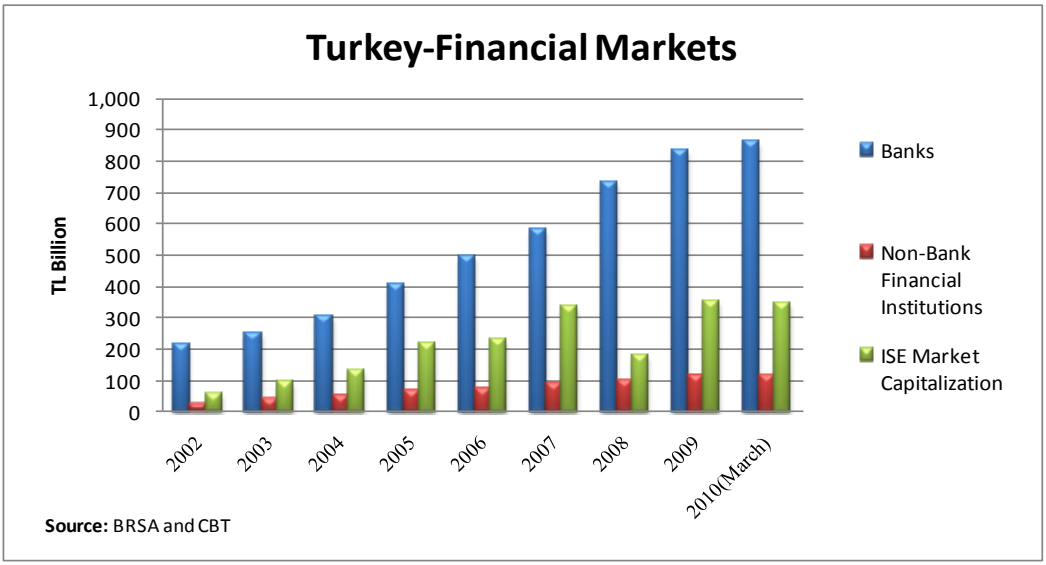


Table 2.1: Turkey-Asset Size of Financial Sector (TL m)

Asset Size of the Financial Sector	2003	2004	2005	2006	2007	2008	2009	2010
Central Bank of Turkey	76.5	74.7	90.1	104.4	106.6	113.5	110	128.4
Banks	249.7	306.4	406.9	499.7	581.6	732.5	834	1007
Financial Leasing Companies	5	6.7	6.1	10	13.7	17.1	14.6	15.8
Factoring Companies	2.9	4.1	5.3	6.3	7.4	7.8	10.4	14.5
Consumer Finance Companies	0.8	1.5	2.5	3.4	3.9	4.7	4.5	6.1
Asset Management Companies	na	na	na	na	0.2	0.4	0.4	0.7
Insurance Companies	7.5	9.8	14.4	17.4	22.1	26.5	33.3	31.0
Pension Funds	*3.3*	*4.2*	*5.7*	*7.2*	*9.5*	*12.2*	*15.7*	17.8
Securities Companies	1.3	1	2.6	2.7	3.8	4.2	5.2	8
Securities Investment Trusts	0.2	0.3	0.5	0.5	0.7	0.6	0.7	0.7
Securities Mutual Funds	19.9	24.4	29.4	22	26.4	24	29.6	29.7
Real Estate Investment Trusts	1.2	1.4	2.2	2.5	4.1	4.3	4.7	5.1
Venture Capital Investment Trusts	0	0.1	0.1	0.1	0.2	0.1	0.2	0.2
Portfolio Management Companies	17.8	24.5	30.2	26	31.2	30.7	40	44.9
Total	**382.8**	**454.9**	**590.3**	**695**	**801.9**	**966.4**	**1087.6**	**1292.1**

Source: BRSA, CBRT, UT, CMB, ACMII

The Banking Sector

18. **With a Capital Adequacy Ratio of 18.0 percent (March 2011), and with no major financial distress in the financial system, Turkey has a well capitalized and well managed banking sector**. The Turkish banking sector is highly concentrated with seven banks (Ziraat Bank, Iş Bank, Akbank, Garantibank, Yapı Kredi Bank, Halkbank, and Vakıflar Bank) accounting for 64 percent of the banking assets. About a third of the banking assets are in the form of government securities. The Turkish banking sector has traditionally invested heavily in government securities because of high interest rates offered by the Government and perceived high risks associated with lending to the private sector. As a result, the corporate sector has

relied heavily on borrowing in foreign currency in international markets. The absence of a vibrant corporate bond market in Turkey discourages the corporate sector from sourcing their funds in the domestic market.

19. **Table 2.2 shows the key indicators of the banking system from 2002 to 2010.** Turkish banks rely heavily on deposits (that have a relatively short-term maturity) and borrowings from abroad (mainly in the form of syndicated loan and bonds with short duration) as their sources of funds. Their ability to fund themselves from abroad has been constrained by the overall sovereign rating.

Table 2.2: Turkish Banking System

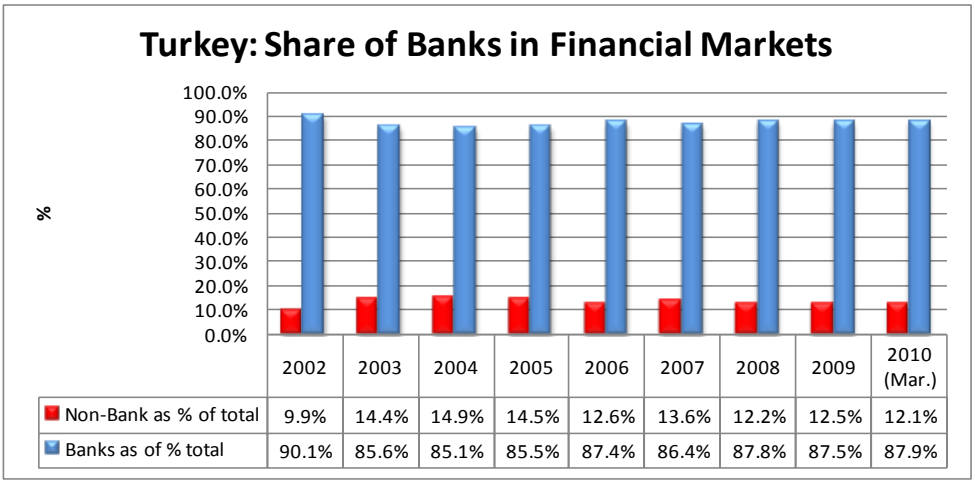
Turkey-Banking System-Key Indicators (TL Billion)											
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Securities	18.5	60.0	86.1	106.8	123.7	143.0	158.9	164.7	194.0	262.9	274.7
Loans	31.8	38.0	49.0	66.2	99.3	156.4	219.0	285.6	367.4	392.6	475.4
Subsidiaries inv	4.2	6.6	8.7	9.2	11.8	11.1	9.2	10.9	10.3	12.7	14.2
Fixed assets	2.5	6.0	7.7	8.3	8.5	7.7	7.4	7.9	9.6	9.7	
Total Assets	104.1	173.4	212.7	249.7	306.4	406.9	499.7	581.6	732.5	834.1	927.4
Deposits	58.9	110.4	138.0	155.3	191.1	251.5	307.6	356.9	454.6	514.6	573.0
Funds from abroad'	3.8	2.8	11.0	17.0	22.0	36.0	49.0	61.0	62.0	58.0	
Own-funds	7.2	18.3	25.7	35.5	46.0	54.7	59.5	75.8	86.4	110.9	126.9
Net Profit	-3.1	-10.5	2.9	5.6	6.5	6.0	11.4	14.9	13.4	20.2	16.8
Off-Balance Sheet	105.0	87.5	75.3	107.2	527.6	206.0	277.4	385.5	476.0	579.8	937.7

Source: BSRA

Non-Banking Financial Institutions

20. **Major NBFIs in Turkey include mutual fund companies, insurance companies, brokerage firms, private pension companies, financial leasing and financial factoring companies**. Other NBFIs include real estate investment trusts, consumer credit companies and venture capital companies. As shown in Figure 2.5, the share of NBFIs in financial markets has steadily declined from 18.5 percent in 2003 to 13.5 percent in 2010. As of September 2010 out of the 424 firms operating in the financial sector, 375 were NBFIs.

Figure 2.5: Turkey – Share of Banks in Financial Markets



	2002	2003	2004	2005	2006	2007	2008	2009	2010 (Mar.)
Non-Bank as % of total	9.9%	14.4%	14.9%	14.5%	12.6%	13.6%	12.2%	12.5%	12.1%
Banks as of % total	90.1%	85.6%	85.1%	85.5%	87.4%	86.4%	87.8%	87.5%	87.9%

21. **The portfolio management sector represents the fastest growing segment of the NBFIs, and it has grown considerably in the last few years.** The share of financial leasing companies declined to 47.1 percent. There were 78 factoring companies operating within the NBFIs in September 2010, and it was a rapidly growing sector. The growth of the factoring sector can be largely explained by the global financial crisis that led to a significant decline in bank lending for account receivables. Insurance companies also experienced a decline in their assets and profitability. The bright spot in the NBFIs sector was the continued growth of private pension funds.

22. **Thus far, the NBFIs have played a limited role in Turkish financial markets**. Their growth has been stunted by the unstable macroeconomic condition in the past and the dominance of the banking system. These institutions are also not structured to generate long-term investable funds. East Asian economies' experience with bond markets showed that institutional investors have played a major role in facilitating their development. There is a clear need to tap the role of the NBFIs in Turkish financial markets to provide alternative funding sources for the Government and corporate sector.

Turkish Financial Markets vis a vis Selected Emerging Market Countries

23. **Figure 2.6 shows the financial market composition of selected emerging market countries. Five countries (Brazil, Malaysia, South Korea, Thailand, and South Africa) have been selected for comparison purposes with Turkey.** In 2009, the size of the financial markets of these five countries was substantially greater than Turkey's market. Malaysia and South Africa have achieved high levels of financial market deepening due to concerted efforts made by their key decision makers to develop these markets, and supportive macroeconomic conditions. Both countries also have large investor bases, with high savings rates. Malaysia meets most of its investment requirements through the domestic capital markets. South Korea has also built a diversified financial market following the 1997 Asian financial crisis, with the bond market being substantially restructured following the crisis. Malaysia adopted a 10-year capital markets master plan that helped guide the development of its capital markets over the last decade. Thailand accelerated financial market reforms following the crisis to repair and rebuild

its financial markets. These efforts have been successful, and Thailand now has a well functioning financial market with sound macro prudential regulations in place. Brazil has successfully built an investor base during the last 10 years and has successfully restructured the profile of government debt by refinancing most of its foreign currency denominated debt in Brazilian Real.

Figure 2.6: Financial Markets as % of GDP



24. **As a percentage of GDP, the Turkish banking system is roughly comparable to the benchmarks.** However, the significant gap in the stock market capitalization and the bond market indicate that both Turkish stock and bond markets have substantial room to grow if economic growth is sustained and additional reforms are carried out. The Turkish bond market has grown rapidly during the last five years. However, it only accounted for 34.2 percent of GDP in 2010, as compared to 113.4 percent of GDP in South Korea, 100 percent of GDP for Malaysia and 69.7 percent of GDP for Thailand. Turkey's bond market consisted largely of government bonds until the end of 2010. The benchmark sovereign yield curve in Turkey is only 22 months (though its being lengthened constantly), which is considerably shorter than five years, which is the case in all these five countries. Starting December 2011, the new benchmark will be the two year fixed rate coupon bond. The issuance of corporate bonds in Turkey in 2010 is expected to increase by sevenfold from 2009 to 2011, be it from a lower base.

Table 2.3: Selected Emerging Market Countries: Composition of Financial Markets

	Composition of Financial Markets (% of GDP, 2010)			
	Bond Market	Banking System*	Stock Market	Financial Markets
Brazil	63.9	102.9	76.4	243.2
Malaysia	100.0	178.0	187.5	465.5
South Korea	113.4	102.7	110.4	326.6
Thailand	69.7	110.4	88.8	268.9
S. Africa	47.1	97.2	285.7	430.0
Turkey	34.2	91.1	43.9	169.2

Sources: Central banks, BIS, authors' calculations

*Data for all countries updated until 2009, except for Turkey which is for 2010.

CHAPTER 3

Corporate Bond Market of Turkey

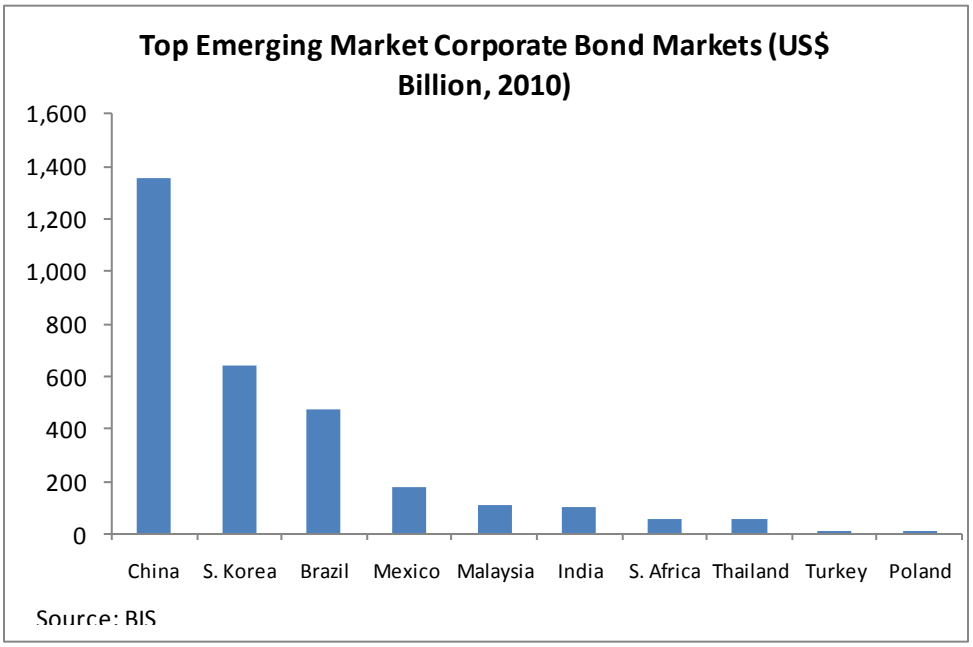
Introduction

25. **The Asian financial crisis of 1997 brought to the fore the importance of a diversified domestic financial market that can meet the funding requirements of the government and the corporate sector, without increasing systemic risk for the financial markets and economy**. Diversified financial markets reduce the currency and maturity mismatch for the corporate sector. They also reduce the vulnerability of the corporate sector during global financial crises, limiting access by emerging-market corporations. Since 1997, several emerging markets have made notable efforts to develop domestic bond markets, as the benefit of a robust corporate bond market is well appreciated by policy makers. As a result, East Asian countries and Latin American countries such as Brazil and Chile, with diversified and deep domestic capital markets, did well during the recent global crisis.

26. **Turkey has the sixth largest local currency bond market among the emerging market countries. However, its corporate bond market amounted to only TL481 million (US$340million) at the end of 2009, jumping up to TL1.4 billion[5] (US$1.9 billion) in end 2010 and to TL4.3 billion in end 2011**. This is still very small in comparison to other major emerging market countries (Figure 3.1). The corporate bond market in Turkey was relatively active during 1992-1997 with bank bills accounting for a major share of issuance as shown in Table 3.1. Investment and commercial banks were active in issuing bank bills. However, the corporate debt market shrank dramatically after 1997 due to unstable macroeconomic conditions, high inflation, and crowding out by the public sector as the Government became the major bond issuer in the domestic market to finance its growing fiscal deficit. Another factor that impeded the growth of the bond market was the distortionary withholding tax structure, with 10 percent levied on interest income from corporate bonds as compared to zero withholding tax on interest from government securities. This distortion has since been corrected. Since 2007, the corporate bond market has gained momentum due to the general improvement in macroeconomic conditions and decline in the domestic interest rate. In October 2010, the Turkish corporate bond market got a major boost, with the decision by the BSRA to permit banks to issue TL debt instruments in domestic financial markets. As a result, the size of the corporate bond market in 2010 increased by fivefold to TL2.5 billion. In January 2011, the Government of Turkey reduced the transaction tax on corporate bonds in the secondary market from 5 percent to 1 percent to create a level playing field with government securities so as to stimulate secondary market trading. Most of the new issues in 2010 and 2011 have a maturity of up to two years, and all have an investment grade rating on the national scale.

[5] This includes pure corporate and financial institutions issuances; this does not cover bank bills.

Figure 3.1: Top Emerging Corporate Bond Markets (US$ Billion, 2010)



Corporate Bond Markets in Emerging Market Countries

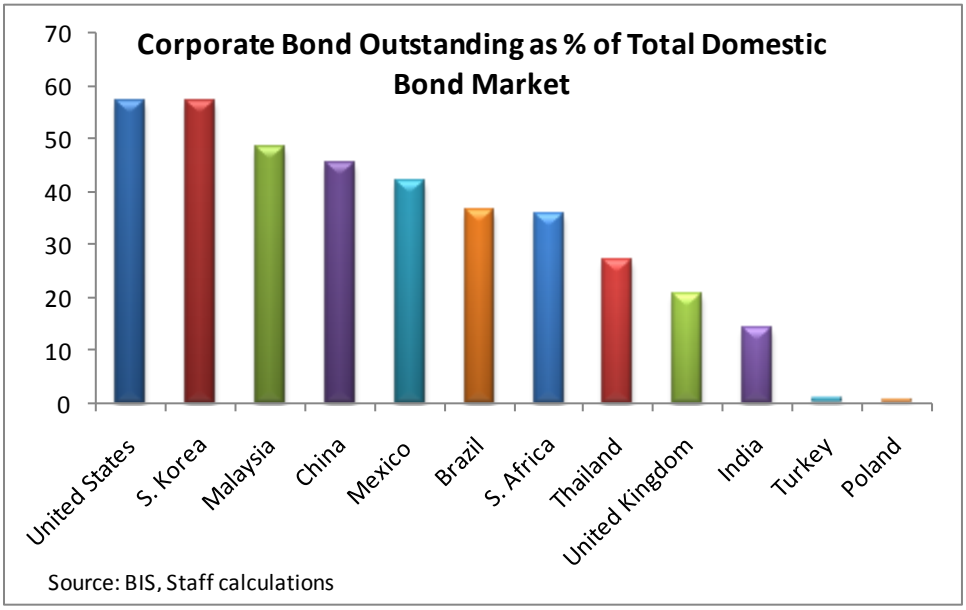
27. **In most emerging market countries, sovereigns are the major issuers of bonds followed by financial institutions and the corporate sector as shown in Table 3.1.** Prior to the Asian crisis of 1997, the corporate bond market did not exist in most emerging market countries. In fact, there were no government bond markets in most of these East Asian countries because their governments were running fiscal surpluses, with no necessity to borrow. The East Asian experience, especially for South Korea and Thailand, was that the corporate sector borrowed heavily from international markets. The corporate sector was the major casualty of the currency devaluation and reversal of portfolio flows as the international credit markets disappear. In addition, the insolvency of many of these companies had led to a large pool of non-performing loans in the banking system. Since 1997, striking development has taken place in the bond market in emerging markets, especially in the East Asian economies. For these East Asian countries, governments were forced to issue large amounts of government bonds to restructure and recapitalize financial institutions to avoid systemic failure. As a result, most East Asian countries have been successful in developing government bond markets, and they have gained considerable experience in managing domestic public debt. Latin American countries, especially Brazil, Chile and Mexico, have also successfully developed their government bond markets.

Table 3.1: Composition of Selected Bond Markets by Type of Issuers (US$ Billion, 2010)

Composition of Selected Bond Markets by Type of Issuers (US$ Billion, 2010)				
	Gov	**Fin**	**Corp**	**Total**
China	1,616.90	859.00	493.10	2,969.10
S. Korea	480.60	271.90	366.20	1,118.70
Brazil	821.90	461.70	9.70	1,293.30
Mexico	239.40	140.80	33.30	413.50
Malaysia	112.80	45.00	61.00	218.80
India	606.80	75.10	24.90	706.80
S. Africa	107.60	34.00	25.30	166.90
Thailand	159.60	1.50	56.90	218.00
Turkey	236.40	1.80	0.40	238.60
Poland	199.90			199.90
Major Developed Bond Markets				
United States	10,746.00	11,523.90	2,888.10	25,158.00
United Kingdom	1,343.80	321.90	21.30	1,687.00
Spain	606.00	837.20	22.90	1,466.10
Germany	1,555.50	708.80	424.90	2,689.20
Frnace	1,695.50	1,207.70	295.30	3,198.50
Italy	1,974.80	730.50	376.20	3,081.50
Japan	11,212.80	1,206.40	855.90	13,275.10
World Bond Markets	37,873.50	21,897.30	6,564.40	66,335.20
Source: BIS, Staff calculations				

28. **Building a corporate a bond market is logically the next step for emerging market countries**. Diversification and growth of the market for corporate bonds is crucial in meeting the funding requirements of the corporate sector that relies heavily on international financial markets. Nonetheless, corporate bond markets still account for a small part of local currency bond markets in most emerging market countries. Emerging markets continue to face considerable hurdles in building the domestic corporate bond market. These hurdles include: small issuance size that leads to low liquidity; narrow investor base; distortionary or unattractive tax treatment for bond investments; poor disclosure of financial information, and weakness in corporate governance accounting and audit standards. Be that as it may, there are success stories such as Malaysia, Thailand, Chile, South Africa, and China, which have been able to build relatively deep corporate bond markets in terms of percentage of GDP (Figure 3.2).

Figure 3.2: Corporate Bond (including FI) Outstanding as % of Total Domestic Bond Market (2010)



Primary Market

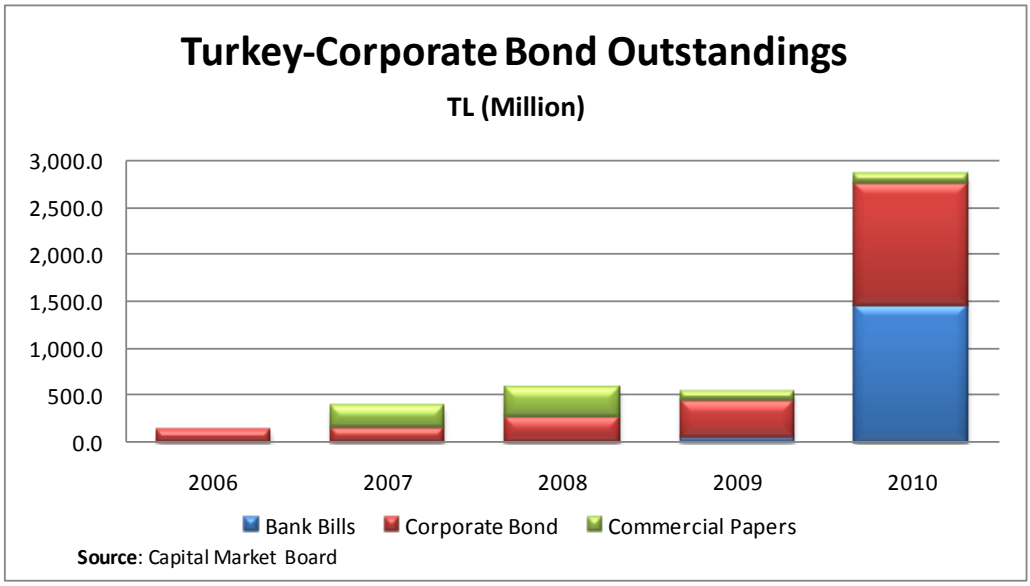
29. **Since 2001, the Government of Turkey has carried out major macroeconomic and financial market reforms that have made positive impacts on the real economy and the financial sector**. The Turkish Lira has become more stable and domestic interest rates in Turkey have steadily declined. As a result, the general environment has been positive for the development of the corporate bond market. The corporate bond market in Turkey has started to revive, and the amount of corporate bonds outstanding rose fivefold as of end of 2010 from 2009 (Table 3.2). There were a record number of issues (14), including five public issues. The largest issue (TL1.0 billion) was from Akbank, a major commercial bank. The maximum tenure of these issues was two years, compared with the average maturity of 42 months for government securities. The spread on public issues ranged from 60 to 450 basis points over the 22-month Turkish benchmark zero coupon bonds.

Table 3.2: Turkish Corporate Bond Market (1992 – 2010)

	Amount Outstanding (TL '000)				
	2006	**2007**	**2008**	**2009**	**2010**
Corporate Bond	132,690,997	151,028,000	255,992,500	381,080,000	1,291,817,000
Commercial Papers	0	230,000,000	320,000,000	100,000,000	105,000,000
Bank Bills	0	0	0	55,551,200	1,458,743,561
Total	132,690,997	381,028,000	575,992,500	536,631,200	2,855,560,561
Nationalty					
Domestic	56.27%	83.57%	99.67%	99.95%	91.30%
Foreign	43.73%	16.43%	0.33%	0.05%	8.70%
Investors					
Individual	22.05%	13.29%	10.04%	14.65%	14.18%
Intutional investors and others	77.95%	86.71%	89.96%	85.35%	85.82%

Source Central Registration Agency

Figure 3.3: Turkey – Corporate Bonds (TL Million)



30. **In addition to general improvement in macroeconomic conditions, the CMB — in consultation with the key participants in the capital markets — implemented a number of measures during the second half of 2009 to remove key impediments, such as higher withholding tax on corporate bonds.** In the interest of accelerating the development of the corporate bond market, both CMB and ISE introduced measures to reduce issuance and transaction costs of corporate bonds respectively. However, these measures had limited impact on corporate bond market activities, as the focus of the reform was to facilitate the issuance of corporate bonds by small and medium enterprises (SMEs). Although this objective of promoting access to finance for SMEs is laudable, it is more important to create appropriate incentives for large and high quality companies in Turkey to issue bonds; this will create a critical mass of high quality bonds that will attract institutional investors (who are constrained by their investment policy in investing in lower grade bonds).

Bank bonds in TL

31. **Until recently, the mechanism for issuance by commercial banks in TL was not very clear in Turkey**. A major milestone for the development of the domestic corporate bond market in Turkey was reached on October 10, 2010, when the Bank Regulations and Supervisory Authority (BRSA) issued guidelines[6] setting out principles and procedures relating to the issuance of TL bonds by Turkish banks in the domestic market. Banks interested in issuing bonds through either public offerings or private placements domestically will have to comply, with a minimum total regulatory capital adequacy ratio of 12 percent. The Public offering circular must explicitly state that the bonds are not covered by the deposit insurance for savings deposits. In addition, the issuing banks must submit detailed financial reports to the BRSA, providing an analysis of expected costs and benefits, potential risks and risk mitigation plans. The issuing banks must be in full compliance with sound corporate governance prescribed by

[6] BRSA issue 2010/36, October 1, 2010, Principles and Procedures Concerning the Banks' TL bond and Bill Issues.

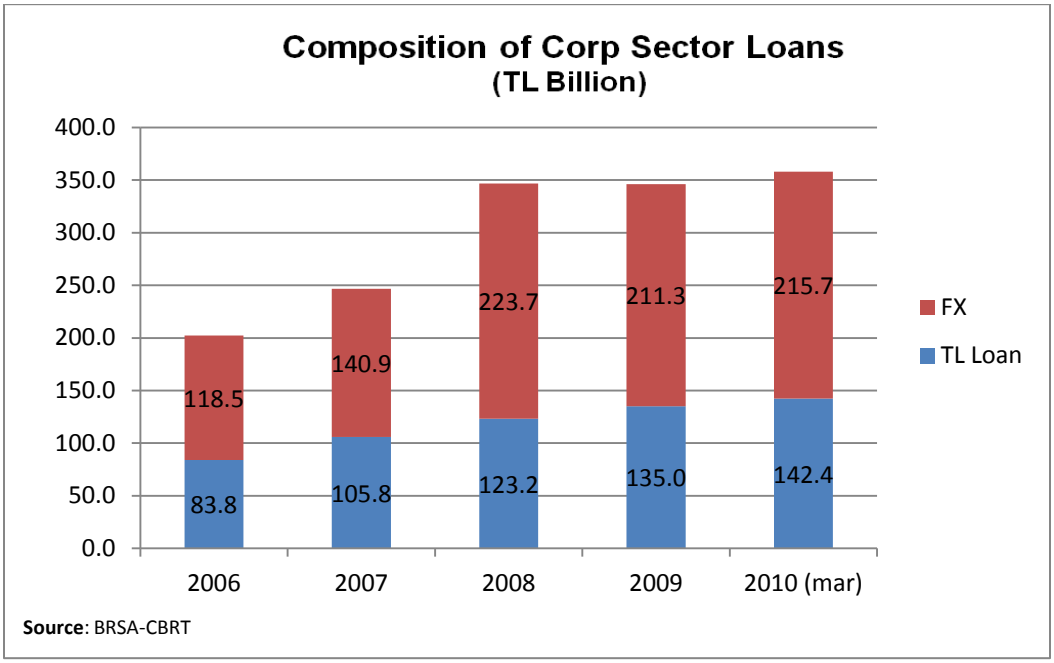
BSRA. The guidelines cover domestic debt issues (both short and long-term). Subordinated debt, hybrid issues and asset-backed securities are excluded. The maximum amount of domestic debt each bank can issue is a dynamic function taking into account equity, saving deposits, asset size and capital adequacy.

32. **Based on the BRSA's guidelines, it is estimated that Turkish banks (excluding development and investment banks) can potentially have up to TL51 billion in outstanding TL debt instruments in Turkey**. Thus far, two commercial banks (Akbank and Garanti) have announced plans to issue TL short-term bills or bonds totaling TL4 billion. Therefore, the size of the corporate bond market is expected to grow rapidly, with the entry of top banks that are in sound financial condition and enjoy high credit rating.

Non-bank Corporate Issuers

33. **The overall leverage ratio of the corporate sector is in line with other major emerging market countries.** At the end of September 2009, the total debt/equity ratio of companies listed on the ISE was 1.06 (CBRT), which is comparable to East Asian countries. However, the funding of the corporate sector in Turkey is subject to multiple risks that include currency risks, maturity risks and interest rate risks. Therefore, exchange rate fluctuations have a major impact on the leverage ratio and debt service capabilities of Turkish companies. In addition, the corporate sector's reliance on foreign exchange funding makes it vulnerable when credit markets dry up, due to international financial market turbulence.

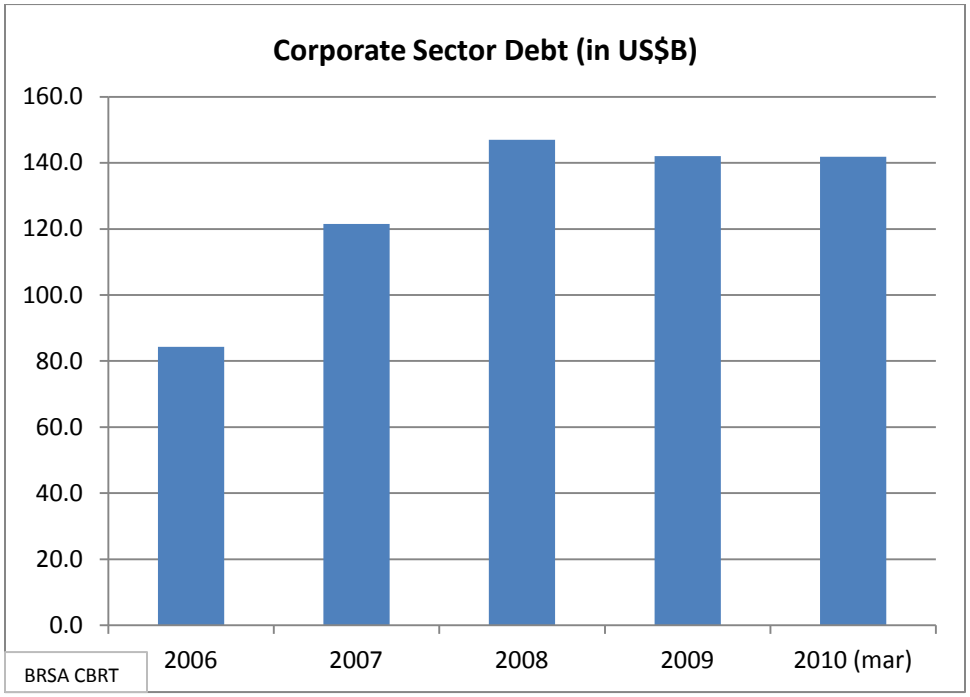
Figure 3.4: Composition of Corporate Sector Loans



34. **Since there are practically no alternative funding sources in domestic financial markets other than the commercial banks, the corporate sector has largely relied on international financial markets for their financing requirements.** Borrowing in foreign currencies increased sharply from US$84.3 billion in 2006 to US$141.8 billion at the end of

March 2010 (Figure 3.5). As of March 2010, the next foreign exchange exposure (excluding deposits in foreign exchange) was US$80 billion (CBRT) making the corporate sector highly vulnerable to rollover risks.

Figure 3.5: Corporate Sector Debt in FX



35. **The corporate sector in Turkey is also subject to roll over and maturity mismatch risk**. As of March 2010, 27.1 percent of borrowings from abroad had a maturity of up to one-year only. The major risk here is the rollover risk in that credit markets may dry up during financial turbulence as the loans mature. This was highlighted during the recent global financial crisis when the access to international financial markets was curtailed for major emerging market borrowers. In addition to currency and maturity risks, the corporate sector is also highly exposed to interest risks. As of March 2010, 69.3 percent of loans received by the corporate sector were floating rate loans. Rising international interest rates will have a major impact on the profitability of the Turkish corporate sector.

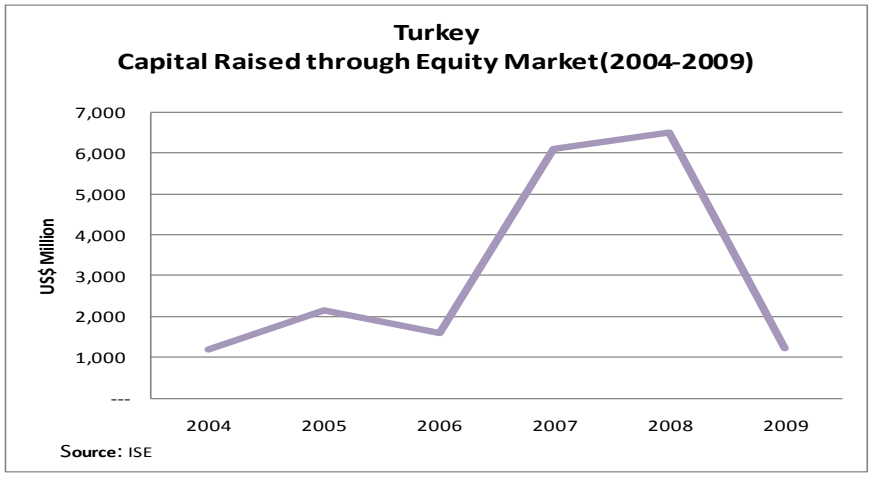
36. **The Turkish corporate sector has been successful in weathering unstable macroeconomic conditions that Turkey experienced for a long period in the past**. Turkish corporations remain highly dependent on bank funding, with limited financing from debt capital market issuance. Approximately 60 percent of local banks' borrowings is short-term, mainly in the form of trade credits. Large Turkish corporations are able to borrow from the banking system at attractive rates, while there are very few buyers of SME bonds.

37. **The ability of the corporate sector to access international capital markets is constrained by the credit rating ceiling for Turkey that makes accessing funds from international capital markets relatively more expensive.** The corporate sector is also required to register its offerings with CMB for issuing bonds in TL abroad. The current regulation does not permit issuance of foreign currency bonds in domestic bond markets, although lending in

foreign currency by Turkish financial institution is allowed. The present situation exposes the corporate sector to both foreign exchange risks and interest risks. Funding in local currency would enable the corporate sector to minimize both currency and maturity mismatches and lessen the impact of volatile foreign capital flows.

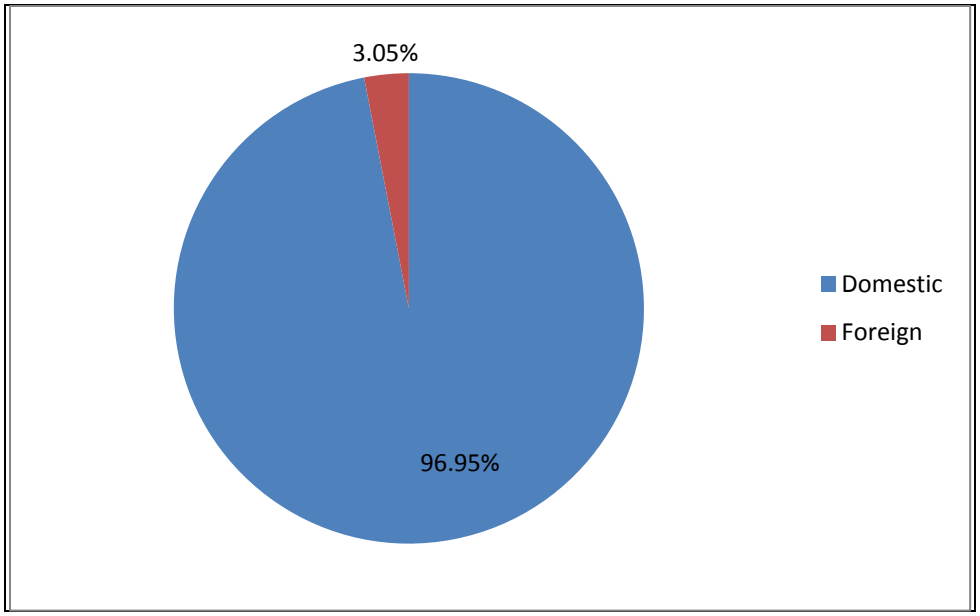
38. **The Turkish stock market has been one of the top performing emerging stock markets during the last three years**. The valuation of the stock market (in terms of price/earnings ratio and other market valuation measures) has increased sharply. The buoyant domestic stock market has also lowered the cost of capital for issuing equity vis-à-vis debt for most listed Turkish companies. However, the corporate sector did not appear to have taken full advantage of the market conditions by issuing new shares or through secondary offerings. As shown in the Figure 3.6, the total amount of funds raised through equity offerings during 2004-2009 was only US$18.7 billion. This can be partly explained by the corporate ownership structures in Turkey that are highly concentrated, with few families having controlling interests in large companies listed on the ISE. These companies typically raise financing from banks and internal funds. In 2010, the amount of funds raised in ISE increased sharply to US$7.9 billion, reflecting better market conditions and a sharp increase in the ISE index.

Figure 3.6: Turkey – Capital Raised through Equity Market (2004 – 2009)



39. **The non-bank corporate sector in Turkey will clearly benefit from a more robust domestic corporate bond market that can provide long-term fixed rate funding on attractive terms.** This will allow corporations to undertake additional investments, without being exposed to interest rate and currency risks. In this regard, the development of a domestic institutional investor base is vital. At the end of 2010, foreign investors own only 3 percent of the outstanding corporate bonds (Figure 3.7). It is also interesting to note that the local corporate debt market in Turkey is essentially a high net worth individual market, with very limited participation from pension funds, insurance companies or mutual funds.

Figure 3.7: Corporate Bond Ownership by Nationality (2010, %)



40. **Listing Criteria[7].** All corporate bonds are required to be registered with the ISE. The registration criteria include: (i) the nominal value of the issue (at least TL1,100,000); (ii) 100 percent offering to the public; (iii) a minimum three calendar years of operations; (iv) audited financial statements for at least one year; (v) profitable operations; and (vi) a minimum equity of TL1.76 million. Although these are sound criteria, they are more appropriate to the issuance of new equity or IPO (Initial Public Offering). The threshold for issuing a bond is too low and appears to be targeted to SME issuers. The experience of South Korea has shown that developing a corporate bond market through a SME focus has largely failed and has been highly problematic.[8] SME bonds are too small for meaningful trading in the secondary market and pose too high a risk for individuals and institutional investors. The ISE and the CMB should consider amending listing criteria to encourage large blue chip companies to list their bonds on the ISE, by providing some form of incentives such as a faster turnaround time for issuance. Increasing access to capital for SMEs is important, but better financial access is achieved over the longer term through maturity in the financial sector. Development of the corporate bond market will indirectly lead to increased SME lending by Banks, as they will need to diversify their client base once certain companies start issuing bonds. As well, banks themselves will raise longer-term money on the market, that they can then intermediate down to SMEs.

Secondary Market

41. **A well functioning secondary market requires not only a sound policy framework, but also supporting institutional infrastructures,** such as market based risk free benchmarks; well capitalized market makers; efficient clearing and settlement systems; credit rating agencies;

[7] ISE
[8] Ismail Dalla and Jae Hoon Yu, *The Korean Bond Market-The Next Frontiers, KSDA,* June 2008

liquidity financing; and central market information system. Turkey has most of these requisite infrastructures with an efficient clearing and settlement system in place. Turkey also has a well functioning money market that is a prerequisite for the development of a bond market. The primary dealership (PD) system for Government Bonds needs to be extended to corporate bonds.

42. **Nonetheless, there has been sporadic secondary market trading of corporate bonds listed on the ISE.** As in other major financial markets, corporate bonds in Turkey are traded in the Over-the-Counter (OTC) market. Since the total size of corporate bonds is miniscule compared to the size of the government bond market, there have been no incentives for financial market intermediaries to build capacity in this area. The government bond market in Turkey is one of the most liquid in the world, and it has a well-developed system of Primary Dealers (PDs). No such system exists for the corporate bond market.

43. **Therefore, it is important that the primary policy focus for the authorities over the next two to three years must be to increase the supply of corporate bonds from high quality and creditworthy companies in Turkey.** The Government can also consider inviting multilateral development banks to issue bonds in TL in the local market to broaden the range of high quality products in the corporate bond market. In this regard, the issuance of bonds by public utility companies could also be encouraged.

Impediments facing the development of the corporate bond market

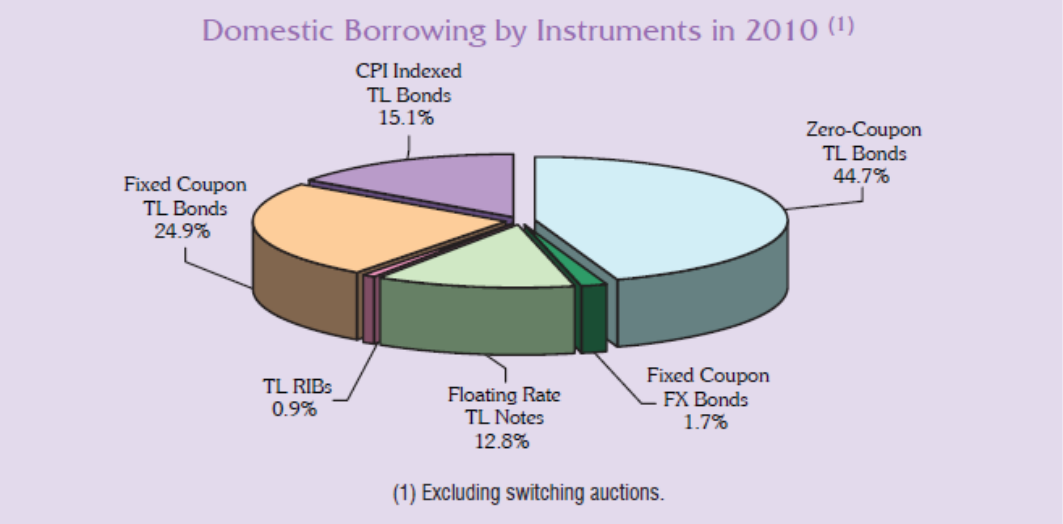
44. **Sovereign Benchmark Yield Curve.** Benchmarks play a crucial role in the efficient functioning of both the primary and secondary bond markets. They serve a variety of purposes. They are used as a bell-weather to gauge the prevailing interest rate structure, the market expectation of future movements, inflation and the associated risk premium. They provide hedging vehicles for some underwriting and trading risks, and they help identify that portion of issuance yields, which pertain to credit and default risk. Investors in fixed income securities are exposed to a variety of potential risks depending on the local market condition. The major sources of risk include: (i) business risk (or default risk); (ii) interest rate risk; (iii) liquidity risk; (iv) purchasing power risk; and (v) issue-specific risk (e.g. reinvestment risk, call risk and other special credit events). Given the risks involved in investing in fixed income securities, the availability of market-based benchmarks is essential to price these securities.

45. **The availability of benchmark securities, with different maturities helps promote active trading in the secondary market** since they reflect the prevailing market interest rate. Availability of a meaningful sovereign benchmark yield curve, together with appropriate supporting market infrastructures, would foster the development of hedging and risk management products and facilitate efficient pricing of the corporate bond market.

46. **In 2010, the Turkish Government's borrowing in TL denominated zero coupon bonds, TL denominated floating rate notes, TL denominated CPI indexed bonds, TL denominated fixed coupon bonds and FX-denominated coupon bonds accounted for 44.7, 12.8, 15.1, 24.9 and 1.7 (percent) respectively**. The current widely used benchmark is 22-month TL zero coupon bonds. In 2009, 22-month TL zero coupon bonds accounted for 54.6 percent of the total borrowings of the government. In line with the general decline in global and domestic interest rates, the cost of TL denominated zero coupon bonds decreased sharply from

16 percent in early 2009 to a historically low level of 7.5 percent in October 2009. To further lengthen the yield curve, the Government of Turkey auctioned a 10-year fixed coupon bond in January 2010 followed by a 10-year CPI indexed bond in April 2010. These two issues represented the longest auction maturities in local currency in the history of the Turkish Republic.

Figure 3.8: Domestic Borrowing by Instrument in 2010



47. **Range of Issuers.** Currently, mainly SMEs or second tier companies are issuing bonds in the domestic market on a limited basis. It may be pointed out that their funding needs may be better met through the banking system or through private placements. "Blue-chip" companies can be encouraged and incentivized to issue bonds in the domestic bond market. These companies will help create a critical pool of high quality bonds that can credibly provide an investment avenue for institutional investors and enhance the confidence of investors to invest in domestic corporate bonds. In addition it would diversify the funding base for blue-chip companies. East Asian countries (South Korea, Malaysia and Thailand) have used tax incentives to make it attractive for the corporate sector to issue bonds in the local market. At this stage of the development of the corporate bond market in Turkey, the Government's strategy must be to build a pool of bonds that are issued by blue chip and high quality companies. This is essential to maintain the confidence of the investing market in providing credible avenues of investments by institutional investors whose liabilities need to be matched with assets that are of high credit quality.

48. **Investor Base.** Domestic institutional investors (pension funds, insurance companies and mutual funds and other collective schemes) are critical for the growth of the domestic bond market as they have the need for long-term local currency assets to meet their actuarial obligations. They are the most crucial part of the demand side of the domestic bond market both government and corporate. In 2010, the size of domestic institutional investors in Turkey amounted to TL61 billion, or about 5.8 percent of GDP, which is very small when compared to

other OECD countries. Thus far, institutional investors in Turkey have played a limited role in supporting bond market development.

49. **Market Intermediaries.** The issuance of corporate bonds has increased notably in 2010, and the issuance for 2011 is likely to be over TL8 billion. Banks are the major issuers. There is currently no market-making arrangement for corporate bonds. Furthermore, corporate bonds are not accepted as collateral for margin under the rules of ISE. Liquidity and pricing of the corporate bonds will become a problem that needs to be addressed to avoid valuation problems. The authorities, together with the ISE, could consider creating a market-making system for corporate bonds as soon as possible: this needs attention and not much capital investment. The current practice of settling the trade of corporate bonds on T+0 needs to be amended to T+2 to facilitate trading by dealers, especially for foreign investors who place orders abroad.

50. **Market Infrastructures (trading, clearing and settlements).** The systems used in clearing, making payments and settling the securities trades are crucial for the development of bond markets. Turkey has built a well functioning clearing and settlement system for the securities market. Takasbank is regulated by both the CMB and the BRSA. The settlement of transactions is done through Delivery Versus Payment, with daily netting. Takasbank requires collaterals against its lending to brokers. Acceptable collaterals include cash (TL, FX), Letters of Guarantee (TL, FX), Treasury Bills and Government Bonds, Mutual Funds, and Equities. A 25 percent haircut is applied for equities and other assets that are valued at market prices. Corporate bonds are not accepted as collaterals by the Takasbank, for active secondary market trading. It would be important that Takasbank accepts highly rated corporate bonds as collateral.

51. **Credit Rating.** Although the recent global financial crisis has highlighted some weaknesses of the credit rating agencies, these agencies remain essential because it is too costly for most investors to carry out independent due diligence to assess credit risks. The credit rating industry in Turkey is at an early stage with mixed quality. Out of the "big three," there is only one international rating agency operating in the country (Fitch). The Government needs to carry out an assessment of the local rating agencies, with the view toward raising their standards to the international level. In Malaysia, prior to July 2000, all corporate bond issues were subject to a mandatory minimum rating requirement of BBB or above, which helped to instill confidence and indirectly contributed to the development of the relatively new rating agencies (RAM and MARC). Although the minimum rating requirements on credit ratings have been removed (mandatory rating is still required), the credit profiles of corporate bonds in Malaysia remain skewed towards the higher end of the credit spectrum (single A and above), with approximately five percent of outstanding corporate bond issues rated BBB or below.

52. **Encouraging local credit rating agencies to form joint ventures with international rating agencies is a step in the right direction**. Mandatory ratings also need to be considered for public offerings of corporate bonds. Requiring mandatory rating of issuers in the future would inevitably increase the issuance cost that might deter some issuers from entering the market. Nonetheless, it would greatly improve investor confidence in corporate bonds. All blue chip issues are already rated by the issuers.

53. **Liquidity and pricing issues.** Given the very small size of the corporate bond market in Turkey, and the small issuance size, there is practically no trading in outstanding corporate bonds. They are *de facto* loans, with a different label. The authorities need to consider additional measures to promote liquidity including extending the securities borrowing and lending facility to institutional investors (Box 3.1). This will provide an additional source of revenue for institutional investors and increase business opportunities for PDs. Repos can be introduced for corporate bonds, and corporate bonds could be eligible for margining. It needs to be noted, however that globally liquidity in corporate bonds is low, and they are typically held to maturity by a variety of investor base, a base that is missing in Turkey.

54. **The experience of Malaysia would be of interest to the Turkish authorities - Box 3.1**

Box 3.1 Malaysia
Measures to further enhance liquidity in the domestic bond market

Malaysia has been at the forefront of developing its domestic bond market. However, liquidity in the secondary market was limited. To further enhance the efficient functioning of the ringgit bond market, Bank Negara Malaysia (BNM) in January 2005, announced the introduction of several measures to foster the development of a more liquid market, with improved price discovery process.

The specific measures introduced by the BNM were:

- Active use of repurchase agreements (repo) as a monetary policy instrument;
- Introduction of Institutional Securities Custodian Program (ISCAP) to enable borrowing and lending of securities; and
- Securities lending facility for principal dealers.

Use of repurchase agreements as monetary instrument

To further develop the repo market, BNM started using repo operations as part of its monetary policy instruments to manage liquidity in the banking system. It repo operations are aimed at (i) encouraging market participants to actively use repos as an alternative funding instrument; (ii) enhancing the flexibility for market participants to use these securities in managing settlement risks and trading strategies; and (iii) further strengthening the banking industry's risk management capabilities by encouraging banks to move towards collateralized inter-bank transactions.

Borrowing and lending securities via ISCAP

ISCAP is a web-based custodian system developed by BNM to encourage the participation of institutional investors in securities lending activities. Through ISCAP, BNM will borrow securities from major institutional investors, such as pension funds and insurance companies. The borrowed securities, mainly Malaysian Government Securities (MGS), will be used by BNM for its repo operations. By "freeing" the captive holding of MGS by the institutional investors to market participants, the overall liquidity in the bond market will be further enhanced

Securities lending facility for principal dealers

A securities lending facility for the 10 principal dealers was also introduced to facilitate market-making activities and promote competitive pricing. In doing so, principal dealers will enhance their ability to provide and quote continuous prices for MGS and improve further the price discovery process and

promote liquidity in the secondary market. The securities of this lending facility will be sourced from ISCAP or from BNM's own MGS holdings. Since the sufficient supply of MGS is crucial for a successful securities lending facility and repo operations, BNM may also purchase MGS from primary and secondary markets based on market prices. To ensure that these purchases do not influence or distort market prices, the purchase of MGS at primary tenders will be based on the weighted average price of the tender and limited to a maximum of 10 percent of the issue size. The amount purchased in the secondary market is limited to 10 percent of the outstanding issued amount.

The above measures have contributed positively toward the development of a more liquid ringgit bond market.

Source: BNM's press release dated January 7, 2005.

55. **Risk Management Products.** Turkey has been one of the most active equity derivative markets in the world, although with limited product offerings. The development of derivatives and risk management products for the debt market is still at an early stage of development. The interest rate swap market has grown rapidly, but most transactions take place in the OTC market. There is a clear need for the Government to develop the exchange traded derivative market to reduce risks and improve transparency. The experience of Singapore in developing this market would be of interest to Turkey: the Monetary Authority of Singapore took steps, such as easing the entry and compliance costs of firms engaging in financial and commodity derivative activities. A vibrant derivative market will foster the development of risk management products (interest rate, credit and foreign exchange), which would in turn further deepen the Turkish bond market.

56. **Investor protection in case of insolvency.** According to Article 206 of the bankruptcy law (icra iflas kanunu), the ranking of payments are in the following priority:

- Claims based on a pledge (including bonds that pledged by assets);
- Employee's rights;
- Living allowance, guardianship, related claims according to family law;
- Claims stated privileged in their own laws, such as Publics Claims-AATUHK article 21/3 (Procedure of Public Receivables);
- Insurance policy holders in case of insolvency of insurance companies;
- Turkish deposit insurers' claims and bank depositors' claims for the portion that is not paid by the deposit insurer in the event of a bank insolvency;
- Lawyer fees;
- All Other Receivables including unsecured bondholders;
- Preferred stock holders; and
- Common Stock holders.

57. **It would seem that there is much confusion and uncertainty among market participants as to how these bond holders would rank, as compared to other classes of creditors in the event of insolvency of an issuer**. Clearly, there is a need for some clarification so that all participants concerned understand the actual legal interpretation. The delays in execution of collateral and bankruptcy proceedings, as well as in reaching decisions in complex financial cases, may also be issues that need to be addressed. This issue is well recognized by

the Turkish authorities, who have agreed that effective protection and enforcement of creditors' rights would be a reform that is a part of the Istanbul International Financial Center (IFC-Istanbul) project.[9] In addition, corporate bonds are not currently included under the Investors' Protection Fund, and there is clearly a need to correct this oversight. To attract both domestic and international investors, the authorities need to take immediate action to amend this law.

58. **Taxation.** The Government needs to consider removing distortions in the financial markets created by taxation for equal treatment of all financial instruments, regardless of who the investors are. Examples of the distortions include Banking and Insurance Transaction Tax (BITT), which carry different tax rates between corporate and government bonds. Until December 2010, banking insurance and transaction tax was one percent for government bonds and five percent for corporate bonds. This was recently amended and this action will foster development of the secondary market in corporate bonds. Another example of tax distortion is the withholding tax on bank deposits and government bonds. The withholding tax on government bonds of 10 percent, compared to 15 percent tax on bank deposit for retail investors. This creates distortion and increases the attractiveness of government securities. These taxes need to be equalized for major financial instruments.

[9] SPO, Strategy and Action Plan for Istanbul International Financial Center, October 2009.

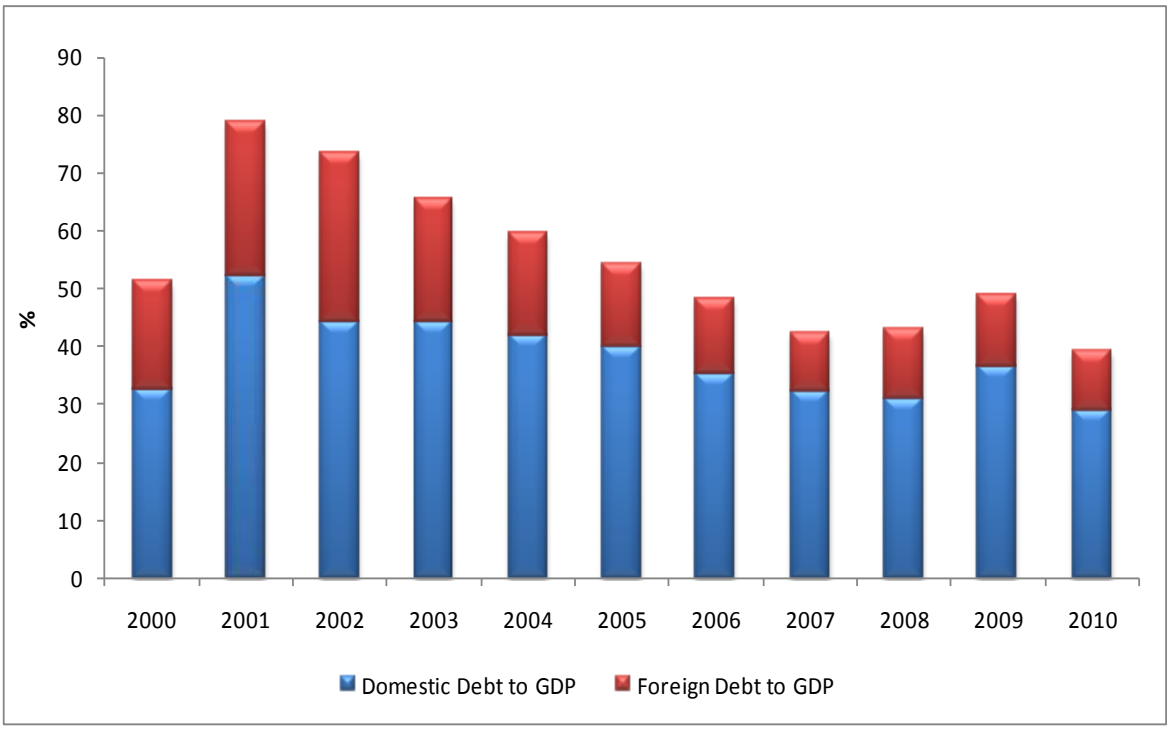
CHAPTER 4

Government Bond Market and Turkey in the Global Context

Introduction

59. **Turkey has successfully built a well-functioning government bond market, which is a key pre-condition for a corporate bond market**. Since 2002, the Government has been able to reduce the overall level of debt, and also materially change the composition of its debt. At the end of 2010, total central government debt stock amounted to TL473.5 billion, with TL dominated debt standing at 73 percent, up from 62 percent in 2005. The cost of borrowing has also declined steadily from 10.7 percent in 2002 (US$ borrowing) to 6.3 percent in May 2011. The major transformation of the government debt market is an outcome of concerted efforts by the authorities since 2001. Achievements so far include: (i) the creation of a sovereign benchmark yield curve; (ii) a well functioning Primary Dealer System; (iii) efficient market infrastructures (trading, clearing and settlement); (iv) a liquid secondary market trading; and (v) a transparent market that is attractive to foreign investors. Looking ahead, there is a need to: (i) increase the portion of fixed rate bonds in the debt stock; and (ii) diversify the investor base.

Figure 4.1: Turkey – Debt to GDP (2001 – 2010)



Source: Turkish Treasury

60. **The major transformation of the government debt market is an outcome of concerted efforts by the authorities since 2001**. Overall, macroeconomic stability and a successful restructuring of the financial markets created the environment for the development of a government bond market. The share of fixed rate debt in TL- denominated debt stock has steadily increased from 36.9 percent in 2002 to 49.5 percent in June 2011. In addition, the average duration of the TL denominated cash-based debt stock has more than doubled, from a level of 5.2 months in end 2003 to 12.5 months in July 2011. Achievements so far also include:

- The creation of sovereign benchmark interest rates up to 22 months;
- A well functioning Primary Dealer System;
- Efficient market infrastructures (trading, clearing and settlement);
- A highly liquid secondary market trading for government bonds; and
- A transparent market that is attractive to foreign investors.

61. **It is vital and urgent for the authorities to address a number of structural issues to take the bond market development of Turkey to the next level:**

- Continue to lengthen the maturity of government bonds;
    - It needs to be noted that five year TL denominated fixed coupon bonds have become an integral part of the issuance strategy, additionally 10 year TL denominated and 10 year CPI-Indexed were introduced to the instrument set
    - TL denominated two year fixed rate coupon bonds will be the new benchmark bond and issued every month starting December 2011.
- Increase further the portion of fixed rate bonds in the debt stock to reduce vulnerability to global and domestic shocks;
- Broaden the investor base; and
- Increase liquidity for fixed rate coupon bonds.

Primary Market

62. **The government bond market is governed by the Law No. 4749 (Law on Regulating Public Finance and Debt Management),** which became effective on March 28, 2002. The law is modern and comprehensive, and it covers all key aspects of debt management relating to domestic and foreign borrowings; receipt of grants; lending and extension of grant and debts and cash management, in a coordinated manner with fiscal and monetary policies.

63. **The governance of debt management includes a Debt and Risk Management Committee ("DRC").** The DRC is the highest decision-making authority for designing borrowing policies of the public sector and providing coordination among the units responsible for public debt management. The responsibilities of the DRC are set out in the Law No 4749 and in the "Legislation on the Principles and Procedures of Coordination and Execution of Debt and Risk Management," dated September 1, 2002 and No 24863.

64. **A broad range of government securities are issued in the primary market.** These include Treasury bills, Treasury bonds, government debt securities with different features, zero coupon bonds, revenue indexed bond and inflation linked bonds. Treasury bills are securities, with a term less than a year, and they are offered at a discount. Treasury bonds are interest-

bearing debt securities issued by the Government, with a term more than one year, giving their holders the rights of a creditor. Zero coupon bonds are securities without a coupon and which are sold at a discount. Government Debt Securities (GDS) may be issued in TL and foreign currencies, or may be indexed to foreign currencies.

65. **Primary Dealership System (PDS)[10] is widely used in several countries to promote the government bond market**. Some of the countries with developed government bond markets do not have PDS. These include Australia, Germany, New Zealand, and Switzerland. In East Asia, all countries have some form of PDS system. The advantages of having a dedicated group of market makers are that they can guarantee success of the auction in the primary market, and that they can promote liquidity in the secondary market by providing two-way quotes. The role of PDs, their privileges and obligations are summarized in Box 4.1.

Box 4.1 The Roles of Primary Dealers

- A channel between debt manager (issuer) and investor
- Bookmakers and distributors
- Providers of immediate liquidity
- Providers of asset transformation and market making services
- Promoters of continuous market and efficient price discovery
- Agents and relationship managers and educating investors
- Providers of feedback on market operational issues

Obligation of Primary Dealers

- Role of market makers in the effort to support the sale of government securities,
- Firm two-way price quote
- Supply of market information and analysis to the authority

Privileges for Primary Dealers

- Exclusive rights or advantages to bid at auctions
- Exclusive access to blind inter-dealer broker screens
- Permission to perform wider range of activities.

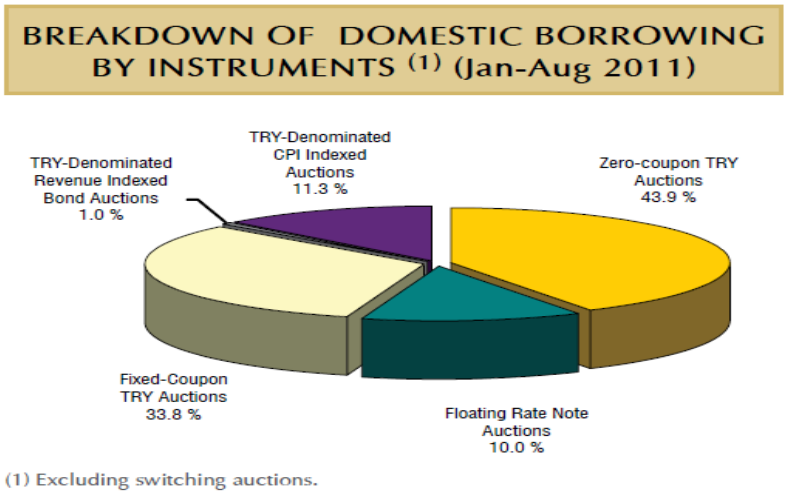
66. **The Government of Turkey has successfully developed a well-functioning PDS for government securities.** In Turkey, the PDS started in May 2000. However, it was suspended during May–September 2001, due to adverse financial market conditions and on-going restructuring of the financial markets. In May 2001, there were 19 PDs but the number was reduced to 10 when the system was activated in October 2001. There are currently 12 PDs. The PD system consists of four three-month periods; January-March, April-June, July-September and October-December. The initial contract period begins on the first day of January and ends on the

[10] For detailed discussion on this subject, please see (i) Marco Arnone and George Iden, Primary Dealers in Government Securities: Policy Issues and Selected Countries' Experience, IMF Working Paper WP/03/45, March 2003; OECD; and(ii) Debt Management and Government Securities Markets in the 21st Century. 2002.

last day of December. The current 12 PDs are major financial institutions operating in Turkey: Akbank, Deutsche Bank Inc, TEB, HSBC Bank Inc, ING Bank Inc, T. Garanti Bank Inc, T. İş Bank Inc, T. Vakıflar Bank, T. Halk Bank Inc, T.C. Ziraat Bank Inc, and Yapı ve Kredi Bank.

67. **Treasury Borrowing by Instruments.** Debt issuance by the Treasury, in the period January- August 2011 is given in Figure 4.2.

Figure 4.2: Domestic Borrowings by Instrument



Source: Turkish Treasury (floating rate notes are in TRY)

68. **The average days to maturity of domestic debt stock was 24.4 months at the end of 2009 and increased to 33.6 months as of June 2011, thanks to the additional issuances of the CPI-indexed bonds and long-term fixed coupon bonds**. Based on the existing debt structure, almost 20 percent of the entire debt stock matures within 12 months, making refinancing and funding a continuous challenge for the Treasury. The duration of the TL denominated cash based debt stock was 12.5 at the end of June 2011[11]. In 2010, the Treasury carried out 58 auctions and raised 99.1 percent of its target borrowing. The remaining 0.9 percent was done through direct sales to PDS. The total bid to cover ratio was approximately 2.3.

69. **The cost of TL denominated zero coupon bonds decreased sharply from 16 percent in early 2009 to its historically lowest level of 6.98 percent in January 2011, due to the general decline in global interest rates and the appetite of foreign investors for emerging market debt instruments.** For 2010 and first half on 2011, the cost of TL denominated zero coupon bonds is 8.12 and 8.10 percent respectively. Decreasing borrowing costs, together with stability of the Turkish financial sector during the global crisis, increased public confidence and contributed to the extension of maturities of GDS.

70. **In January 2010, the Treasury successfully auctioned a 10- year fixed coupon bond followed by a 10-year CPI indexed bond in April 2010 to further lengthen the benchmarks**. These two issues represent the longest auction maturities in local currency achieved in Turkey

[11] Public Debt Management Report No 36, June 2011.

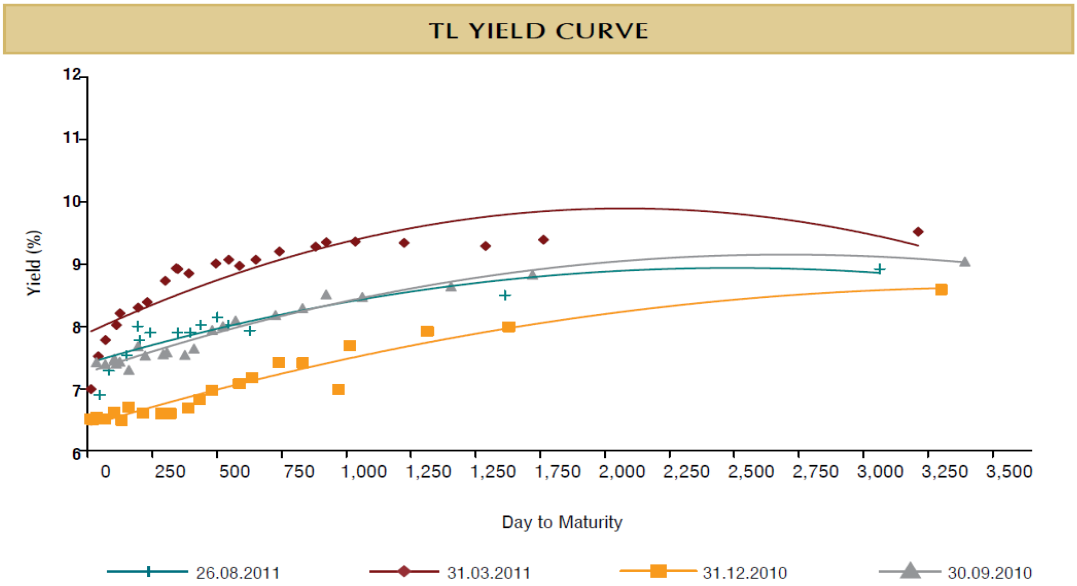
and were reopened several times in 2010 and 2011. Although these bond issues were successfully placed, their liquidity in the secondary market appears limited given the relatively small investor base in Turkey and the limited appetite of foreign investors for long term papers. However, there has been improvement as the liquidity of the issuance has increased in the secondary market and accounted for 10 percent in December 2010. However, via publication of an issuance calendar, such auctions can occur at frequent intervals thereby lengthening the benchmark maturity.

Sovereign Benchmark Interest Rate

71. **Sovereign risk-free interest rate benchmarks play an important role in the efficient functioning of both primary and secondary bond markets.** Benchmarks serve a variety of purposes. They are used as a "bell-weather" to gauge the prevailing interest rate structure, the market expectations of future price movements, inflation and the associated risk premium. They provide hedging vehicles for some underwriting and trading risks, and they also serve to identify that portion of issuance yields, which pertain to credit and default risk. Developing liquid sovereign benchmark securities are essential for improving liquidity in bond markets. Such benchmark securities are required for developing a risk-free yield curve and for efficient public debt management. The availability of benchmark securities, with different maturities, helps develop trading since they reflect the prevailing market interest rate. The availability of a liquid sovereign benchmark securities, together with appropriate supporting market infrastructures, would foster development of hedging and risk management products.

72. **Turkey has made progress in developing a sovereign yield curve (Figure 4.3).** As discussed earlier, the current benchmark is a 22 month zero coupon yield curve. This is notable improvement compared to early 2000s. The Government has also issued two 10-year coupon bond issues in early 2010. However, the active market in GDS takes place at the shorter end of the yield curve. The zero coupon bond reduces interest rate risks for both the Government and the investors as it eliminates reinvestment risks for investors. A longer benchmark bond will require strategic reforms to domestic institutional investors' investment policies.

Figure 4.3: TL Yield Curve



Secondary Market

73. **Turkey has a liquid government securities market comparable to major emerging markets such as South Korea, Malaysia and Thailand**. A liquid market is characterized by the size of transactions and the tightness of bid-offer spreads. If standard transactions are small, participants may not be able to access sufficient liquidity quickly and at reasonable cost. Secondary market liquidity is therefore measured by combining information on the size of standard trades in the secondary market and the bid-offer spread at which this size can be transacted for short (1-3 years) and medium term (3-5 years). In Turkey, the secondary trading of government bills and bonds takes place on the ISE and on the OTC market, with the ISE capturing about 80 to 85 percent of the total volume of trades. As can be seen from the Table 4.1, the average daily trading in the government securities market is relatively large. In 2009, the average trading value was about US$1.0 billion and the trading in the repo market was close to US$5 billion per day. In 2009, repos and reverse repos accounted for 87.73 per cent of the trading volume while the Outright Purchases and Sales Market was only 12.27 percent. As discussed earlier, Turkey's GDS benchmark is 22 month zero coupon bond, and therefore all the trading takes place at very short-end. When repos are taken into account, the average maturity of trade is even shorter at less than one year.

Table 4.1: Turkey – Government Securities-Secondary Market Trading (US$ Billions)

	Turkey					
	Government Securities-Secondary Market Trading					
			US$ Billion			
	ISE Markets		OTC		Total	
	T-Bills	Repos	T-Bills	Repos	T-Bills	Repos
2005	359	1,387	172	251	531	1,638
2006	270	1,770	140	351	410	2,122
2007	279	1,993	184	375	463	2,369
2008	239	2,274	164	366	404	2,640
2009	270	1,929	135	330	405	2,259
2010(June)	158	1,058	76	149	234	1,206
_____						
Source: ISE						

Investor Base of GDS

74. **The major investor group in the GDS market in Turkey is the banking sector.** As shown in Table 4.2, the banking sector's share in GDS market has steadily increased from 44.9 percent in 2004 to 63.5 percent in 2009. GDS holdings are evenly distributed between government-owned and private banks. Foreign banks accounted for about 5 percent of the shares at the end of 2009. The large holdings of GDS by the banking sector could probably be explained by the relatively high real interest rates offered by the Government to meet its financing requirements. One would have expected that the holdings of government securities by the banking sector would have declined, with the general improvement in macroeconomic development since 2004 accompanied by higher lending to the private sector.

Table 4.2: Turkey – Composition of Domestic Debt by Holders

Turkey Composition of Domestic Debt By Holders (%)							
	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010(Sep)**
Banking Sector	44.9	47.1	49.1	51.7	54.9	63.5	62.2
Public Banks	25.6	23.7	24.2	23.4	26.0	27.0	26.2
Private Banks	17.9	21.2	21.5	23.4	23.3	30.8	29.5
Foreign Banks	1.0	1.5	2.9	4.1	4.9	4.9	5.6
Dev Banks	0.4	0.7	0.6	0.8	0.7	0.8	0.9
Non Banking Sector	47.5	46.1	44.0	42.3	40.6	34.2	35.7
Retail investors	14.4	10.5	8.8	5.9	5.5	2.9	1.8
Corporate investors	19.0	17.3	18.1	18.5	19.8	18.5	17.3
Securities Mutual Funds	6.9	8.0	3.5	4.5	5.0	4.2	4.6
Non Residents	7.1	10.3	13.6	13.4	10.3	8.6	12.0
CBT	7.6	6.8	6.9	6.0	4.5	2.3	2.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Public Debt Management Report (No. 63), Oct 2010

75. **During the 2004-2009 period, the holdings of government bonds by the non-banking sector declined steadily from 47.5 percent of the total in 2004, to 34.2 percent in 2009.** A closer look shows that this downward trend may be attributed to the declining participation of retail investors from 14.4 percent in 2004 to 2.9 percent in 2009. The share of the corporate sector remained stable at around 18 percent. The decline in ownership of government securities by retail investors needs further analysis. It is possible that the investable funds available for retail investors declined due to the introduction of private pension plans in 2003. Given that overall savings have remained relatively stable, there seems to have been a reallocation of assets by this group of retail investors. In most East Asian countries, governments have made concerted efforts to increase access to government securities for retail investors to enable them to have a better mix of assets in their portfolio.

76. **Foreign Investors.** Turkey as a country has become more attractive as a destination of international fund managers seeking higher yields and potential capital appreciation. Low interest rates in developed countries have increased the attractiveness of local currency bond markets in emerging market countries. The share of non-resident investors in government bonds increased from 7.1 percent in 2004 to 15.7 percent in May 2011. Notwithstanding the global financial crisis, Turkey has continued to attract investments in its GDS from non-residents. As of November 15, 2010, total investment by non-residents in Turkish GDS amounted to US$34.1 billion (Table 4.3). Foreign banks accounted for 64.1 percent of the investment, followed by non-bank financial institutions (35 percent). Investment by foreign investors in the domestic bond market has recently become controversial as these flows are considered by authorities to be

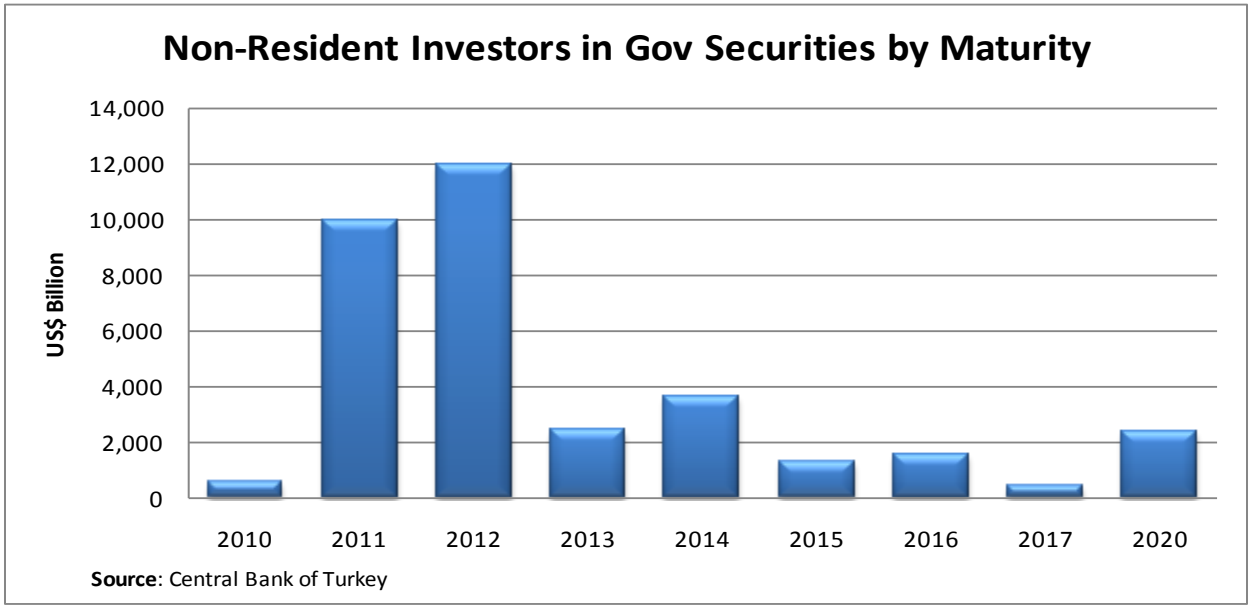
destabilizing in terms of putting pressure on the currency and reducing the country's competitiveness. Many emerging market countries including Brazil, Chile, South Korea and Thailand have imposed withholding taxes and other administrative measures to reduce capital inflows. To date, Turkey has thus far not taken any measures in this direction.

Table 4.3: Turkey – Holding of Government Sector by Non-Residents ($ m as of Nov 15, 2010)

Turkey		
Holding of Gov Sec by Non-Residents		
(As of Nov 15, 2010)		
	Total	**%**
Banks	21,881	64.1%
Foreign Banks	12,770	37.4%
Branches Abroad	9,111	26.7%
Non-Bank Financial Institutions	11,925	35.0%
Non-Financial Institutions	125	0.4%
Retails	187	0.5%
Total	34,118	100.0%
Source: Custodian Banks		

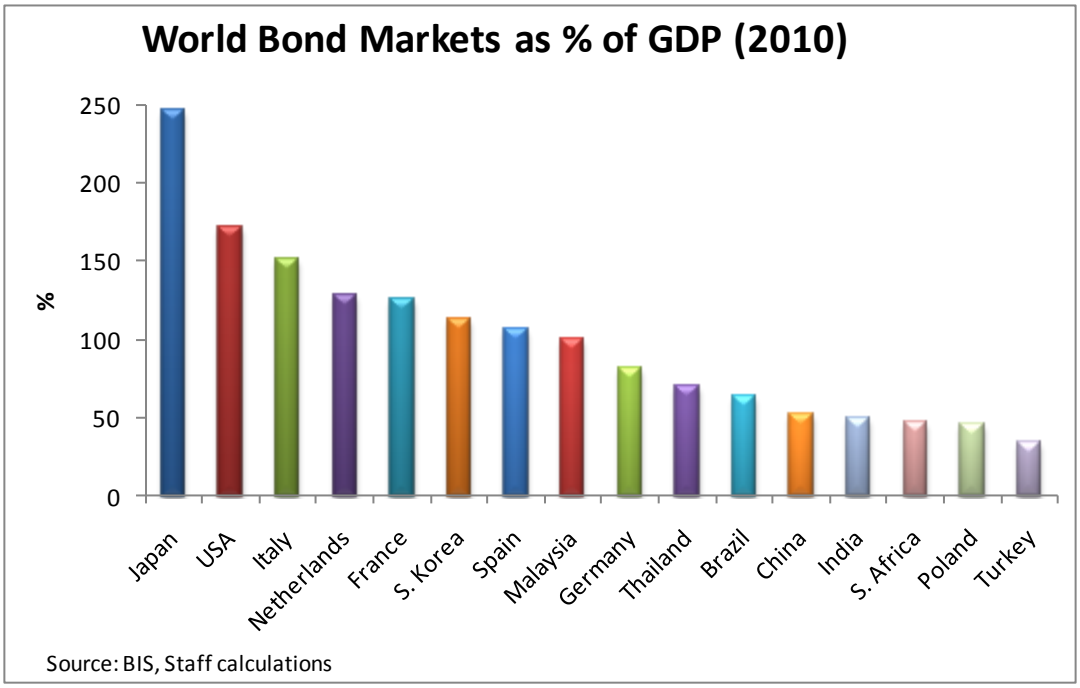
77. **The investment pattern of non-resident investors in government securities has been similar to the domestic investors**. The bulk of investment is in securities, with less than two years in maturity, as shown in the Figure 4.4. However, non-resident investors have been participating in longer-dated bonds on a limited basis. These investors are reportedly overseas Turks, who have high net worth accounts.

Figure 4.4: Non-Resident Investors in Government Securities by Maturity



The Turkish Bond Market in the Global Context

Figure 4.5: World Bond Markets as % of GDP (2010)



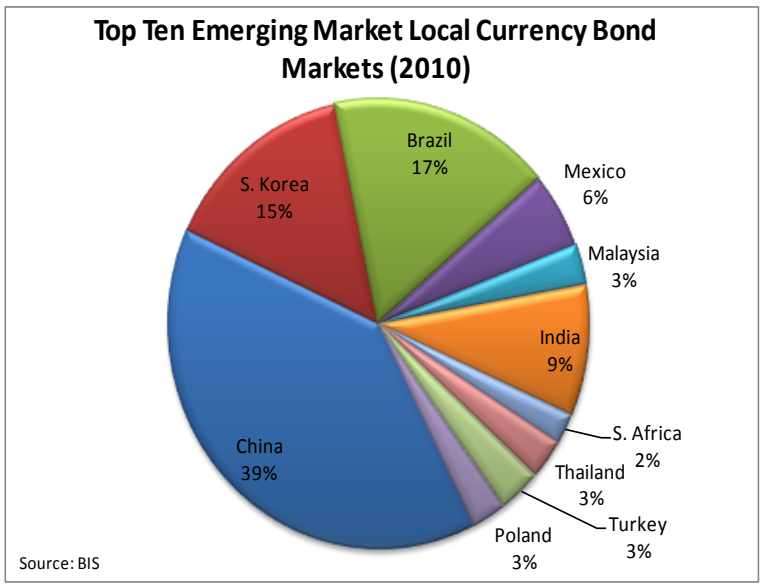
78. **At the end of 2010, the Turkish bond market accounted for 0.35 percent of the global bond market (Table 4.4).** The domestic bond market increased from US$183 billion in 2004 to US$239 billion by September 2010 to meet the funding requirements of the Government of Turkey. The Government of Turkey has done an impressive job in reducing the overall level and restructuring the currency composition of its public debt. However, the size of government debt issuance rose sharply during 2008 and 2009, with the Government of Turkey undertaking a stimulus strategy in response to the global financial crisis. A unique feature of the Turkish bond market is that it is predominantly a government bond market, with a negligible share of corporate bonds.

Table 4.4: Top World Local Currency Bond Markets

	Top World Local Currency Bond Markets						
		(Amount Oustanding in US$ Billion)					
	2005	2006	2007	2008	2009	2010 (June)	%
China	1,183.6	1,687.3	2,209.5	2,565.4	2,646.9	2,843.0	4.5%
Brazil	696.1	952.8	858.8	1,237.2	1,218.3	1,183.7	1.9%
South Korea	982.7	1,076.6	863.5	1,067.4	1,121.8	1,049.1	1.6%
India	325.7	458.4	426.7	603.1	652.1	654.6	1.0%
Mexico	308.9	352.6	319.5	362.8	396.1	404.7	0.6%
Turkey	179.2	218.7	180.6	221.7	224.7	216.4	0.3%
Malaysia	130.9	157.9	172.7	189.3	202.8	205.4	0.3%
Thailand	110.8	140.2	143.4	180.4	194.0	201.3	0.3%
Poland	129.5	162.6	147.8	176.6	193.4	167.8	0.3%
South Africa	109.4	120.7	93.8	140.4	147.7	151.7	0.2%
Netherlands	773.0	903.6	942.1	992.6	939.1	874.2	1.4%
United Kingdom	1,237.6	1,358.1	1,219.3	1,548.8	1,524.5	1,549.9	2.4%
Spain	1,174.7	1,561.5	1,659.2	1,949.0	1,803.0	1,631.9	2.6%
Germany	2,250.0	2,634.0	2,592.5	2,806.4	2,630.3	2,411.3	3.8%
France	2,205.2	2,734.3	2,885.6	3,146.0	3,083.7	2,850.1	4.5%
Italy	2,554.5	3,032.3	3,243.7	3,684.1	3,491.1	3,191.6	5.0%
Japan	8,406.5	8,855.7	11,052.1	11,521.8	11,554.8	12,456.9	19.6%
United States	21,504.5	23,327.4	24,551.5	24,945.2	25,006.9	25,081.5	39.4%
Total World	49,471.6	55,874.2	59,284.9	64,329.0	63,883.1	63,708.7	100.0%
_____							
Source: BIS							

79. **Although Turkey accounts for only 0.35 percent of the global local currency bond markets in 2010, it was the sixth largest emerging local currency bond market in terms of size.** At the end of 2010, the Turkish bond market stood behind only China, Brazil, South Korea, India and Mexico, in terms of size. Turkey has also become an attractive destination for international fund managers seeking emerging market debt instruments with potential currency appreciation, especially as Turkey has an open exchange control and capital market regime. In this regard, foreign investors are exempted from withholding tax on interest income and capital gains from their investments in government bonds.

Figure 4.6: Top Ten Emerging Market Local Currency Bond Markets (2010)



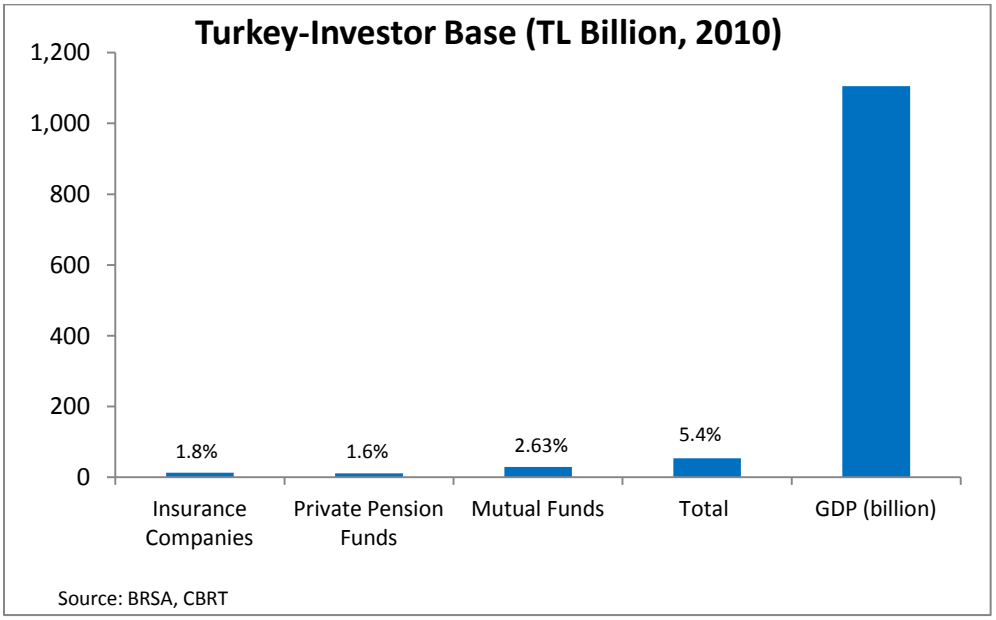
CHAPTER 5

Investor Base

80. **Domestic institutional investors have played an important role in developing the bond market in emerging market countries.** They are the primary purchasers of local-currency bonds, especially government bonds. Pension funds and insurance companies, both of which tend to have very long-term liabilities, are best suited to invest in high-quality debt instruments such as long-term government bonds and high grade corporate bonds. In some emerging market countries (Singapore and Thailand), bond markets have also attracted retail investors looking for relatively safe instruments, with higher yields than bank deposits.

81. **Since 2003, Turkey has made good progress in growing its investor base (pension, insurance and mutual funds); however, there is a long way to go.** High inflation, and the unstable macroeconomic environment in the past, limited the growth of domestic institutional investors. At the end of 2010, the total investor base (Insurance, Pension and Mutual Fund Sector) of Turkey amounted to TL61 billion, or 5.48 percent of GDP (Figure 5.1). Mutual fund companies are the largest component, when measured as a percentage of GDP (2.6 percent), followed by insurance companies (1.8 percent) and private pension companies (1.6 percent)[12].

Figure 5.1: Turkey – Investor Base (TL Billion, 2010)

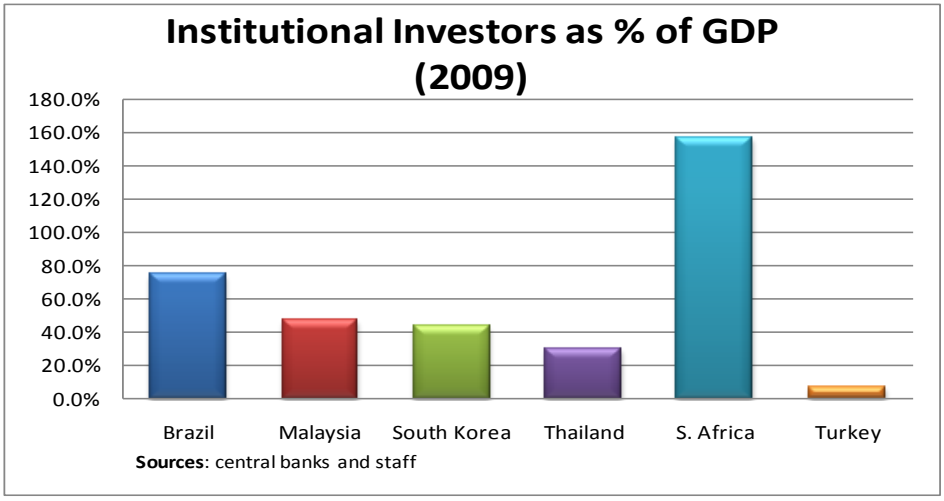


82. **The size of the investor base in Turkey is much smaller when compared to other emerging markets (Figure 5.2).** South Africa has the largest domestic investor base, relative to its GDP, due to the existence of pension funds, insurance companies and mutual funds. South

[12] Private pension mutual funds are operated by 13 pension companies that are licensed by the Insurance authorities.

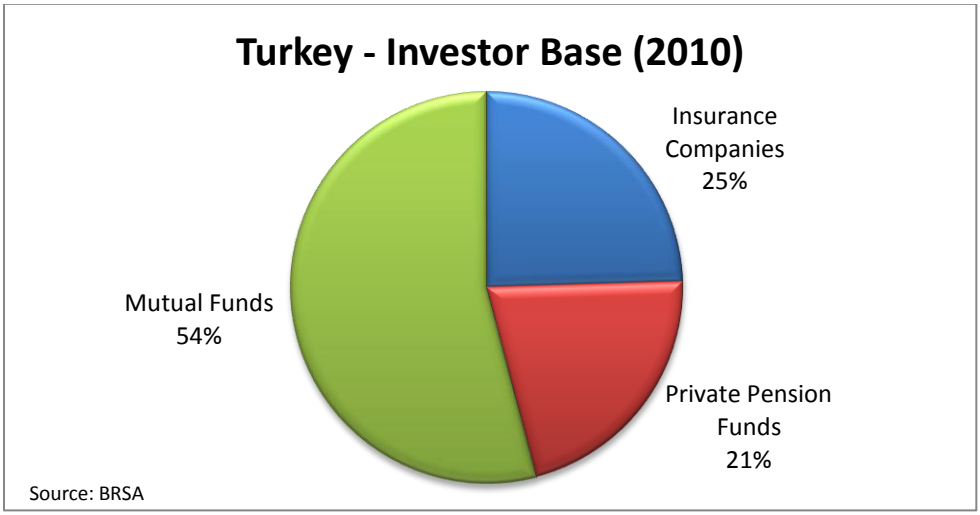
Korea's National Pension System is one of the largest in the world. Malaysia's Employee Provident Fund (EPF) is the major institutional investor in the country and has played an important role in developing the domestic capital market. The existence of a collectively managed large pool of long-term investment funds has enabled countries such as Malaysia and Singapore to finance large infrastructure projects in their domestic bond market. The small and narrow investor base in Turkey is the result of a low savings rate, when compared with other emerging countries like South Africa, South Korea and Malaysia.

Figure 5.2: Institutional Investors as % of GDP



83. **At the end of 2009, mutual fund companies accounted for 47 percent of Turkey's investor base (Figure 5.3).** Insurance companies were the second largest segment of the market accounting for 39 percent. The private pension mutual funds were the smallest segment (14 percent). However, it is the fastest growing segment and offers potential for substantial accumulation of investable funds.

Figure 5.3: Turkey – Investor Base (2010)



Insurance

84. **In 2010, the share of the insurance sector, including the pension companies, was 3.1 percent compared with 3.0 percent in 2003**. As of the end of 2010, there were 57 insurance companies operating in Turkey. Out of 56 insurance companies, 33 of them are licensed in non-life insurance, nine in life insurance and 14 in pension/life business. There is only one licensed reinsurance company in the domestic market. There were 34 foreign companies operating in the insurance sector in 2009. Foreign companies are defined as companies that have more than 50 percent direct or indirect foreign capital. At the end of 2010, they controlled 52.4 percent of the total capital of the sector and 53.3 percent of the total premium.

85. **The insurance industry in Turkey is relatively small, and the total premium in 2009 accounted for 1.3 percent of GDP compared with the global shares of 6.95 percent (Table 5.1).** Therefore, there is considerable potential for growth, with rising per capita income and better appreciation of insurance products among the younger generation. The Turkish insurance industry is dominated by non-life companies that accounted for 85 percent of the total premium of TL12.4 billion in 2009.

Table 5.1: Insurance Industry in Turkey

	Insurance Industry in Turkey			
	2006	**2007**	**2008**	**2009**
Share of Premium in GDP (%)				
World	7.52%	7.49%	7.07%	6.95%
Turkey	1.28%	1.30%	1.24%	1.30%
Share of insurance in Financial Sectors				
Assets of Financial Sector (TL Billion)	670.2	772.0	937.1	1,047.7
Assets of Insurance Sector (TL billion)	18.6	23.4	27.9	33.4
Share of Insurance in Financial Sectors (%)	2.8	3.0	3.0	3.2
Premium in Turkey TL Billion)	**9.7**	**10.9**	**11.8**	**12.4**
Non Life	8.3	9.6	10.2	10.6
Life	1.4	1.3	1.6	1.8
Source: Undersecretary of Treasury				

86. **At the end of 2009, investments in government bonds, treasury bonds and other government debt securities, constituted 74 percent of the total investments by insurance companies, while fixed assets constituted seven percent**. Total investments, including the investment portfolio of reinsurance companies, increased by 31.1 percent from 2008, and amounted to TL11.3 billion. Insurance companies will be logical investors in corporate bonds, if the high quality corporate papers are available at a reasonable price.

Pension Funds

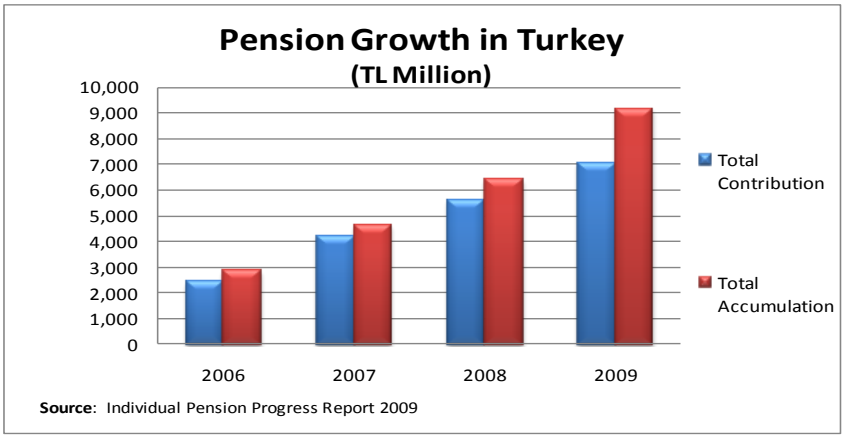
87. **The Turkish private pension system law was approved by the parliament in October 2001 and started functioning in 2003.** The system is a voluntary, defined contribution system

intended to be a complementary scheme to the mandatory social security scheme, which provides retirement earnings to participants on a pay-as-you-go basis. Under the pay-as-you-go system, current retirees are financed through the contributions of the active employees, and the social security schemes are unfunded. The deficit is financed out of the general budget of the Government. The basic characteristic of the defined contribution plan is the retirement fund, which is accumulated and invested in each participant's account. The plan is based on regular contributions of the participant as a fixed proportion of the salary. As such, the retirement earnings under the defined contribution plan depend solely on the level of contributions, administrative expenses incurred and the performance of the investment returns. Under the Turkish private pension system, participation of both employees and employers is voluntary. Portfolio management companies — or Private Pension Mutual Fund Companies as they are known in Turkey — manage the savings in the personal retirement accounts, and the net asset value is reported on a daily basis. The private pension law provides individual account holders with a choice, to diversify pension risks and increase the level of earnings during retirement by directing the individual pension savings into the system. The second objective of private pensions is to create a large pool of funds that will generate new jobs and provide long-term resources in the financial system.

88. **The private pension system in Turkey is regulated and supervised by both the Undersecretariat of Treasury (UT) and the CMB**. In addition, the Pension Monitoring Center was set up on July 10, 2003, with the partnerships of 11 private pension management companies, which are allowed to operate in the private pension system. The Center is based in Istanbul and provides daily information on the activities of the private pension funds. The basic goal of private pension regulation is to have a transparent system, prudent investing of the pension assets, and a healthy actuarial balance.

89. **The private pension plan has grown rapidly since its launching in 2003. The total contribution to the system has increased to TL7.0 billion, and the funds accumulated in the system stood at TL9.1 billion at the end of 2009 (Figure 5.4).** The number of participants in the plan increased from 314,000 in 2003 to 1.9 million participants in 2009. The growth continued during 2010, notwithstanding the global financial crisis and contraction in the Turkish economy, and increased to TL12 billion. At the end of 2009, there were 13 private pension management companies.

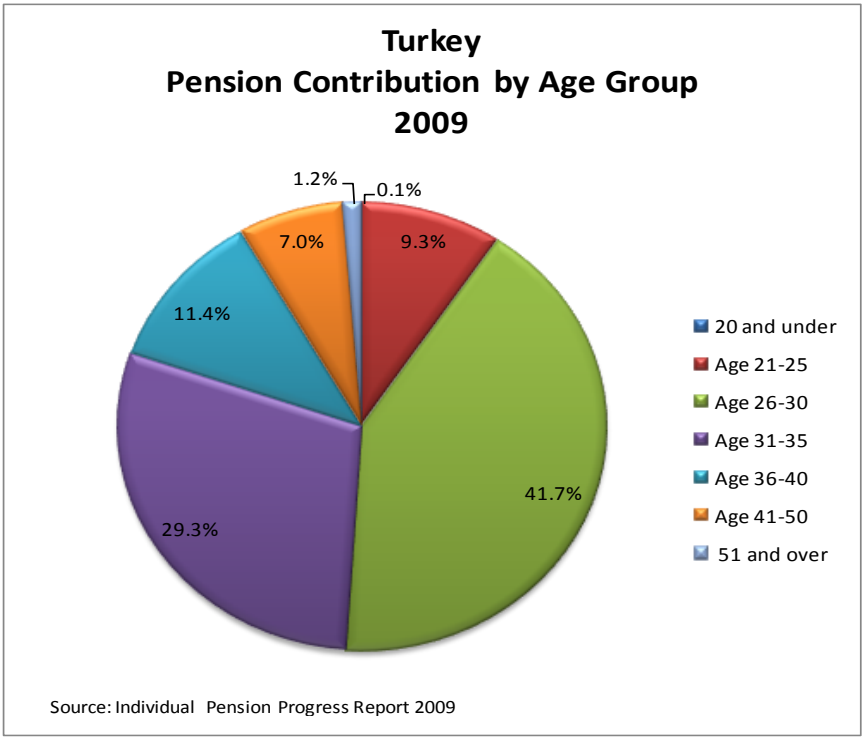
Figure 5.4: Pension Growth in Turkey (TL Million)



Source: Individual Pension Progress Report 2009

90. **At the end of 2009, the size of the private pension system accounted for 1 percent of GDP.** It is the stated goal of the Government of Turkey to increase the size of the private pension system to 10 percent of GDP by 2023. Although this is an ambitious objective, it may be achievable given the demographic profile of Turkey. Figure 5.5 provides a breakdown of pension contribution by age group. At the end of 2009, the age group 26-30 accounted for 41.7 percent of the pension contribution, and the second largest group was the age group 31-35 with a share of 29.3 percent.

Figure 5.5: Turkey Pension Contribution by Age Group (2009)

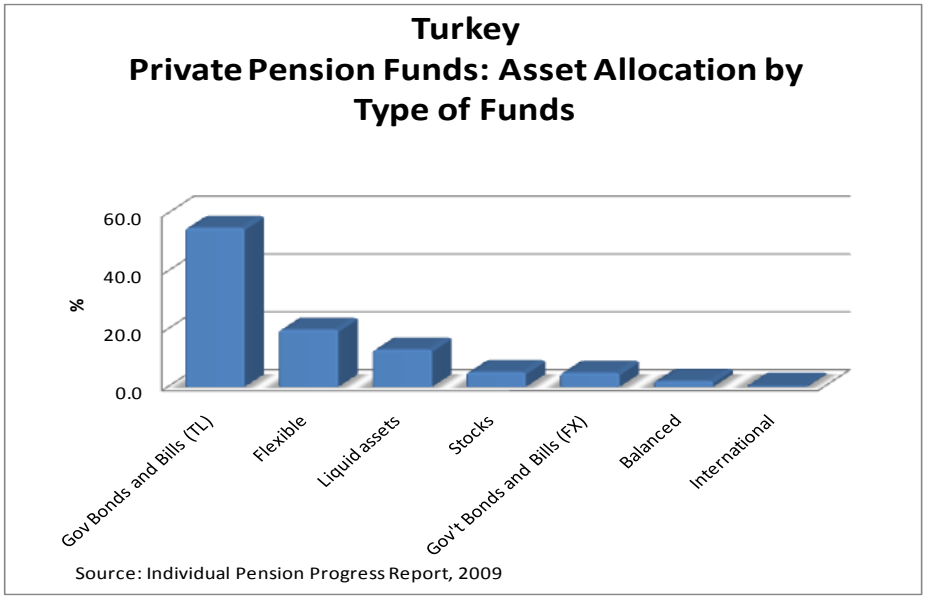


91. **The private pension laws have provided attractive incentives for participants. The contributions are tax deductible (individual income tax and corporate tax up to 10 percent of the employee's income).** Investment returns are tax-deferred. Contributors can change pension management companies once a year, and they can change their allocations among stocks and bonds four times a year. Members gain the right to pension benefits when they contribute for at least 10 years, and when they reach the age of 56. Withdrawal in less than 10 years carries a penalty of 16.5 percent of the total amount accumulated. The income tax rate after the age of 56, and with more than 10 years of contribution, is 3.75 percent.

92. **At the end of 2010, there were 13 private pension management companies and 120 pension mutual funds, with four companies accounting for 72.2 percent of the market.** These companies were Avivasa (22.6 percent), Anadolu Hayat (20.7 percent), YapiKredi (14.9 percent), and Garanti (14 percent). The average management fee was 2.26 percent and administrative fees of 4.1 percent were relatively high by international standards. Higher management fee and administrative expenses reduced the return, and in turn adversely affect the accumulation of the funds.

93. **Asset Allocation and Investment Returns.** Investment by private pension fund companies have been highly conservative and concentrated in Turkish government bonds (about 55 percent), flexible portfolio (12.8 percent), reverse repo (13 percent) and only 5 percent in equity (Figure 5.6). About 5 percent of the portfolio is invested in Turkish government bonds denominated in foreign currencies. These funds are permitted to invest a part of the portfolio in the international markets.

Figure 5.6: Turkey – Private Pension Funds: Asset Allocation by Type of Funds



94. **The private pension system in Turkey is facing major challenges**. The challenges include a large number of withdrawals from the system. It is reported that about one third of plan participants withdraw after three years, notwithstanding the tax penalty of 15 percent of the entire accumulated amount. Operating expenses of the pension system are one of the highest in the world. Operating expenses in 2009 averaged 2.29 percent, compared to less than 0.5 percent for most developed countries. The average management fee was 3.9 percent. The average account contribution in 2010 was TL165, and the average size of account was TL 4128. The size of contribution eligible for tax credit is artificially limited to 10 percent of annual income subject to minimum wages (around TL 9,000) p.a. Since 41.7 percent of the contributors by amount in 2009 were in the age group 26-30 (Figure 5.5), there is significant potential for increasing the size of pension funds if appropriate measures are taken.

95. **One immediate measure that the Government can take will be to double the tax-qualifying limit, from 10 percent of income to 20 percent of income, and to 200 percent of minimum wage.** Assuming that only 50 percent of the participants in the target age group (26-30) respond to this measure, the increase in the deduction limit would generate an annual increase of TL1.5 billion in pension funds. Since pensions are taxed in most countries at the time of retirement, the Government can also consider taxing pensions at the time of retirement. The existing withholding tax rate of 15 percent is too low and reduces incentives for long-term savings. In addition to increasing the tax incentives, the Government can consider taking additional measures to accelerate the growth of private pension funds. These measures could include: (i) increasing the vesting period to a minimum of three years, with no withdrawal

permitted except for medical emergency; (ii) introducing supplemental retirement programs such as the Roth (IRA) in USA to encourage long term savings as returns will be tax deferred; (iii) promoting financial literacy among the three million members who are already in the system and future participants, e.g. students and the general public.

Mutual Funds

96. **Turkey has a well-developed and fast growing mutual fund industry. The first mutual fund was launched in 1987**. At the end of 2010, there were 369 mutual funds in Turkey. As of June 2011, total assets managed by the mutual fund industry amounted to TL41.9 billion (Table 5.2 gives detailed figures up to 2009). Since 2009 to June 2011, there has been growth of 9.5 percent in pension funds and 21 percent in equity mutual funds.

Table 5.2: Turkey – Mutual Fund Industry: An Overview (2009)

Turkey				
Mutual Fund Industry-An Overview (2009)				
		Type A	**Type B**	**Pension Mutual Funds**
Total Assets (TL Billion)	38.75	1.05	28.6	9.1
Stocks		62.6%	0.5%	10.0%
Gov't Bonds and Bills		20.7%	32.4%	68.7%
Reverse Repo		16.3%	60.2%	15.3%
Money market		0.2%	5.3%	0.4%
Foreign securities		0.1%	0.1%	0.3%
Others		0.2%	1.4%	5.3%
Total		100.0%	100.0%	100.0%
_____				
Source: Capital Market Board				

97. **The mutual fund industry is regulated by the CMB under the Capital Market Law. There are three types of mutual funds in Turkey (Type A, Type B and private pension funds).** Type A mutual funds are required to invest at least 25 percent of their assets in equities that are issued by Turkish companies, whereas mutual funds that are not subject to such requirements are classified as Type B. These two types of funds are subdivided into 17 categories that are classified according to the financial instruments: Notes and Bonds; Equity; Sector; Affiliate Companies; Group; Foreign Securities; Gold; Precious Metals; Variable; Balanced/Mixed; Liquid; Index and Exchange Traded Funds; Funds of Funds; Capital Guaranteed; Capital Protected Funds; Hedge Funds; and Private Funds. Among the mutual funds, variable (120), liquid funds (53) and notes and bonds funds (45) accounted for 59 percent of total mutual funds. This is understandable given the high interest rates that can be earned on Turkish government securities and in the repos market until recently.

98. **Type A funds were dormant for a long time due to the requirements that they have to invest 25 percent of their assets in equity.** They have begun to grow rapidly in line with the

general growth of the Turkish stock market. However, they still account for a small percentage of the mutual fund industry. The bulk of the assets of the mutual fund industry continues to be invested in government securities and repos that are highly liquid and provide attractive returns.

99. **Since the introduction of the private pension system in 2003, private pension mutual funds have grown rapidly and reached the size of TL9.1 billion, or 23.5 percent of the mutual fund industry**. Private pension funds are offered by the 13 companies that are licensed by the Undersecretary of Treasury. The private pension fund industry has the potential to play a more important role in supporting the development of the Turkish domestic capital market, as their investment time horizon is longer. At the end of 2009, 10 percent of their investment was made in the equity market.

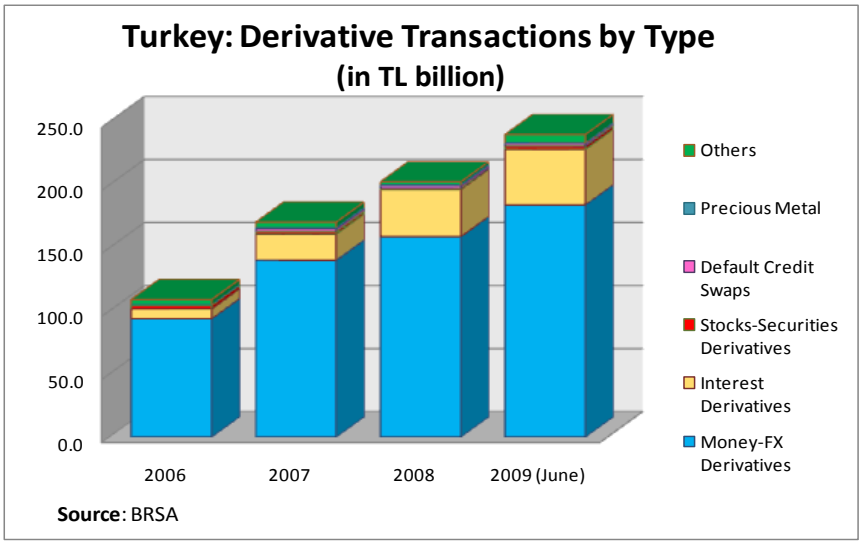
100. **Clearly, a key challenge for the Turkish authorities is to provide the enabling framework, as well as appropriate incentives, to build a broad investor base, with a variety of risks and duration preference.** The Government can set up a high-level task force to coordinate the review of regulations relating to pension funds and insurance companies. Experience of East Asian countries such as Malaysia, Singapore, South Korea and Thailand showed that this is highly effective given the many authorities involved. The investment policies of insurance companies and pension funds need to be reviewed. Insurance companies need to have an investment portfolio that will enable them to meet their actuarial obligations, without violating their fiduciary responsibility. Consideration should also be given to the creation of a supplementary pension scheme, designed and collectively managed by a professional organization.

CHAPTER 6

Derivatives Market

101. **A well-developed derivatives market can foster development of the bond market.** The existence of an active derivatives market in Malaysia and South Korea has contributed to the deepening of their bond markets. Primary dealers need derivatives to hedge their inventory of debt instruments, especially government securities and corporate debt, and to consider the direction of interest rates. This contributes to a liquid secondary market and improves price discovery. There was no formal futures market in Turkey until 2005, when the TURKDEX was established, even though an Over-the-Counter (OTC) derivatives market has existed for quite some time. The OTC derivative market, which is largely a money and foreign exchange market, (Figure 6.1) accounted for 76 percent of the total derivative transactions conducted by the banking sector at end 2009. Interest rate derivatives have started to grow, and the trading volume increased from TL7.8 billion in 2006 to TL44.0 billion during the first half of 2009; however, there is more room for growth. In June 2010, the overall size of the OTC derivatives market was TL 372 billion. There is a need to develop risk management products to promote a liquid secondary market for fixed income securities, i.e. future contracts in government securities and options on futures.

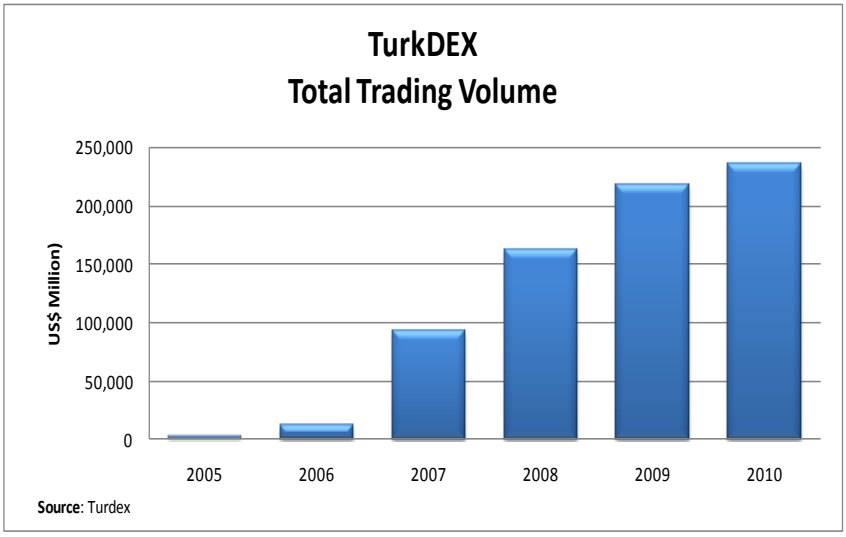
Figure 6.1: Derivatives Transactions by Type



102. **TurkDEX was set up as a corporation in 2002, as a for-profit company with a mandate to offer derivatives in broad range of products.** The shareholders of TurkDEX include the financial and real sector institutions of Turkey. ISE holds 18 percent of the shares of TurkDEX; however the operating environment needs to allow the ISE to issue its own derivatives market. TurkDEX currently offers futures contracts in equity index futures (ISE-30 and ISE-100), and Interest Rate Futures based on Turkish Tresury Benchmark Government Bond (i.e. 22 month zero coupon bond). It also offers future contracts in wheat, cotton and gold. Currency futures are offered in USD and Euro contracts. The ISE-30 equity index futures is the most liquid financial instrument within the overall financial system in Turkey. The contract size

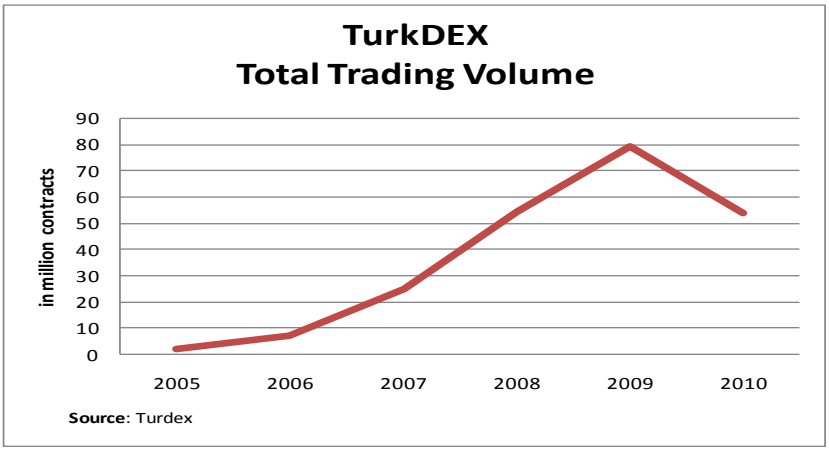
is around US$6,000 and enables retail investors to participate in the market. TurkDEX is one of the fastest growing exchanges in the world. Its trading volume rose from US$2.2 billion in 2005, to US$235 billion during the first 10 months of 2010 (Figure 6.2).

Figure 6.2: TurkDEX – Total Trading Volume



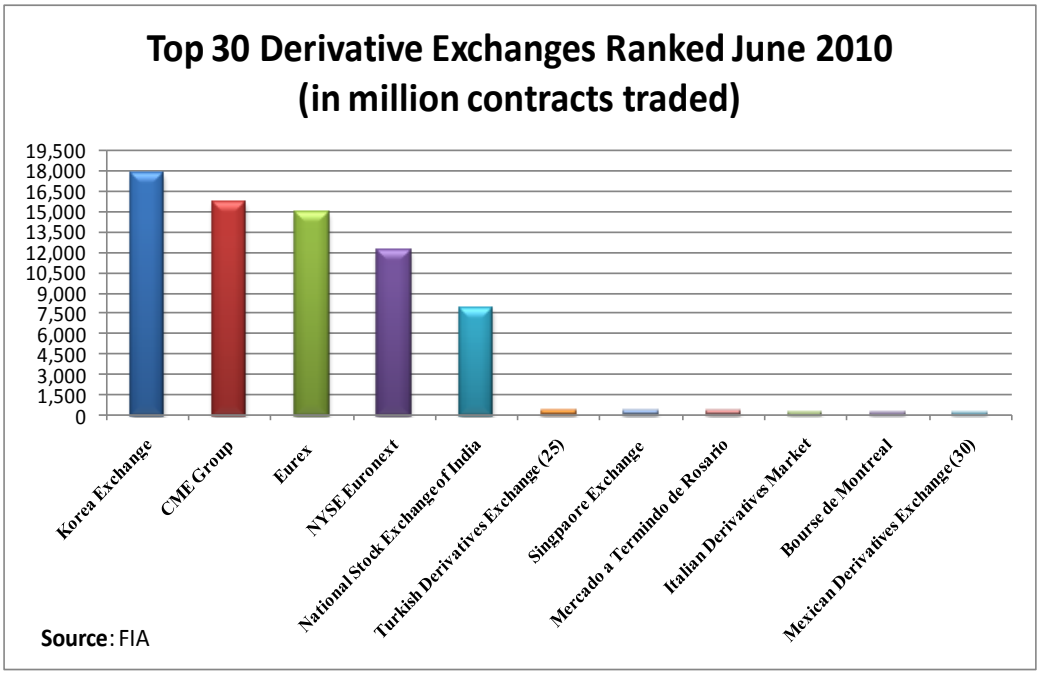
103. **In terms of the number of contracts, the growth was equally impressive**. Trading volume rose from 1.8 million contracts in 2005 to 79.4 million contracts in 2009, before leveling off to 53.6 million (Figure 6.3). Most contracts traded are equity index futures.

Figure 6.3: TurkDEX – Total Trading Volume



104. **Although TurkDEX is a relatively young exchange, it ranked 25th in the world during the first half of 2010 (Figure 6.4), placing it above matured markets such as Singapore and the Italian Derivative Exchange.** However, the product offering is limited**,** and there is considerable room for growth. TurkDEX can play an important role in creating contracts, such as options on interest rate futures, that will be highly useful for bond market participants. There is also a need to make the existing interest rate future more liquid. A future contract on a three-year Turkish Treasury coupon bond will be another possibility to contribute to overall growth.

Figure 6.4: Top 30 Derivative Exchanges Ranked (June, 2010)



CHAPTER 7

A Reform Agenda for Developing the Corporate Bond Market

Building a Robust Corporate Bond Market

105. **Turkey has great economic growth potential, and it is stated government policy to rely on the private sector as an engine for future growth**. Therefore, it is crucial for Turkey to develop a financial sector that reduces its reliance on the banking sector as the dominant intermediation channel. The corporate sector needs to have the option to raise funds from alternative viable sources so that the country can produce goods and services of high quality and compete in the global market place. Building a robust corporate bond market will need concerted efforts by the authorities and it will only succeed if there is a strong political will to remove key impediments. The market will also require coordinated support from the Government and key market participants (issuers, investors, intermediaries and other related organizations such as rating companies, lawyers, and accountants). Building a corporate bond market will take time. A five-year time horizon can be considered normal, based on the experience of East Asian countries. A roadmap to build the corporate bond market, and its key components, is discussed in this chapter.

An Agenda for Reforms

106. Major reforms will impact the following areas.

A. Overall savings of the country (Increase);
B. Supply side (Issuers);
C. Demand side (Investor Base);
D. Benchmark sovereign yield curve;
E. Capital market intermediaries (Investment Banks and Brokerage Firms);
F. Risk management products (Futures and Options);
G. Credit ratings;
H. Regulatory Frameworks (Creditors' Rights);
I. Taxation; and
J. Market infrastructures (Trading Platform, Clearing, Settlement and Custody).

A. Savings. Turkey as a country faces an investment-savings gap as the availability of domestic savings has not been adequate to meet the funding requirements of the corporate sector. In addition, low savings play a direct role in restricting growth due to limited investments. The corporate sector has relied heavily on foreign sources for investment. This situation is almost identical to the situation in Thailand pre-1997 financial crisis. In 1997, Thailand had a very small domestic investor base consisting of provident funds and mutual funds. Therefore, the impact of devaluation of the Thai Baht was very severe on the corporate sector especially as it had a fixed exchange rate. The Government of Turkey is well aware of the need to grow domestic savings, and this subject is being assessed in depth in a separate study. Since 1997, Thailand has

successfully built its domestic investor base, which now includes a large government pension fund, a large and growing social security fund, provident funds and private retirement accounts.

B. Supply Side (Issuers). In Turkey, there is a short supply of high quality issuers. Initially, only small and medium sized companies (SMEs) issued bonds in the domestic market, as the CMB has relaxed issuing standards. Since the issuance size of SMEs is very small and their debt instruments are rated below investment grade by rating agencies, there is practically no liquidity in these bonds. The lack of liquidity and inability to value these bonds can create a crisis of investment trust companies and run on these funds by investors.

SME funding needs are better met through an earmarked program, private placement or through the banking system. Blue-chip companies, including banks, need to be encouraged and incentivized to issue bonds in the domestic bond market. The issuance of bonds by top companies will help create a more liquid corporate bond market; bonds will also provide an investment avenue for institutional investors such as insurance companies that have a natural need for long-term debt instruments but are unwilling to take on the credit risks of SMEs. East Asian countries (Malaysia and Thailand) have used tax incentives to make it attractive for the corporate sector to issue bonds in the local market. Malaysia provided tax incentives by waiving taxes on interest income from corporate bonds for a certain period, and the government reduced transaction costs to make it more attractive for Malaysian corporations to issue bonds locally. The Government can consider adopting such measures, with a sunset clause to spur the market.

Bank Bonds. A major milestone in the development of the domestic corporate bond market in Turkey was reached on October 10, 2010 when the BRSA issued guidelines setting out principles and procedures relating to the issuance of TL bonds by Turkish banks in the domestic market. Banks interested in issuing bonds, through either public offerings or private placements domestically, will have to comply with a minimum total regulatory capital adequacy ratio of 12 percent. The maximum amount of domestic debt each bank can issue is limited to one time bank's capital. The size of the bond issue will vary from bank to bank, as it will depend on the capital strength of each bank. Based on the BRSA's guidelines, it is estimated that Turkish banks can potentially issue up to TL51 billion in new TL debt instruments in Turkey. In December 2010, the Akbank issued a TL1 billion bond, with maturity of one year. Other commercial banks (Is and Garanti) have sought registration from the CMB to issue TL short-term bills or bonds totaling TL8 billion.

Non-Bank Bonds. The potential size of the non-bank corporate sector local currency bond market is about TL115 billion, assuming that the corporate sector refinances its entire net foreign exchange exposure (US$80 billion). The potential market for the corporate bond market in Turkey is very large, but can only be materialized if concerted efforts are made to build the investor base.

C. Investor Base. At the end of 2010, the total investor base of Turkey amounted to TL61 billion, or 5.8 percent of GDP. The small domestic investor base is the major weakness of the Turkish financial markets. High inflation and an unstable macroeconomic environment in the past limited the growth of domestic institutional investors. The government pension system has been transformed into a pay-as-you-go system and has practically no role in the capital market development. The small size of institutional investors (insurance, pensions and other collective investment schemes) limit the ability of issuers to raise funds in the local market outside the banking system. There is an urgent need for the Government to make a concerted effort to increase the size of the domestic investor base. Given Turkey's young population and rising income, the private pension system and insurance offer considerable potential. The existing private pension system is too fragmented and is unlikely to create a large pool of long-term resources that can support the development of the domestic capital markets. Investment policies of insurance companies and pension funds need to be reviewed. Insurance companies need to have an investment portfolio that will enable them to meet their actuarial obligations. They could be potential investors in government securities, with long maturity and high grade corporate bonds.

D. Sovereign Benchmark Yield Curves. Benchmarks play a crucial role in the efficient functioning of both the primary and secondary bond markets. They serve a variety of purposes. They are used as a bell-weather: to gauge the prevailing interest rate structure and the market expectation of future movements, inflation and the associated risk premium; to provide hedging vehicles for some underwriting and trading risks; and to identify that portion of issuance yields which pertain to credit and default risk. Developing liquid sovereign benchmark securities is essential for improving the liquidity of the bond markets. Such benchmark securities are required for developing a risk-free yield curve and for efficient public debt management. The availability of benchmark securities with different maturities helps develop trading, since they reflect the prevailing market interest rate. They would also foster development of hedging and risk management products. Turkish authorities have done an outstanding job in debt management and reducing foreign exchange risks. The current widely used benchmark is 22 month TL zero coupon bond, which in 2009 accounted for 54.6 percent of total borrowings. The average maturity of cash-based domestic borrowing increased to 44.1 months in year end 2010 from its 2008 level of 31.7 months, and it reached 46.2 months as of October 2011.

E. Capital Market Intermediaries. A well functioning bond market requires well-capitalized and efficient capital market intermediaries. Since 2001, the Government of Turkey has successfully developed well functioning PDs for government securities. There are currently 12 PDs, which are major financial institutions operating in Turkey. These banks are well capitalized and well equipped. However, there are currently no market makers for corporate bonds. Ideally, the PDs can become market makers for corporate bonds. This will give them an additional avenue for revenues. The issuance of corporate bonds increased notably in 2010. The outstanding amount at the end of 2010 was TL2.9 billion, compared with TL400 million at the end of 2009. More issues are expected next year. Furthermore, corporate bonds are not accepted as collateral for

margin under the rules of the ISE. Liquidity and pricing of corporate bonds will become a problem that needs to be addressed to avoid valuation problems. The authorities, together with the ISE, should consider creating a market-making system for corporate bonds as soon as possible. The current practice of settling trade corporate bonds on T+0 should be amended to T+2 to facilitate trading by dealers.

F. Risk management products (futures and options). Turkey has been successful in building an active equity derivative market. However, debt market derivatives and risk management products are at an early stage of development. The interest rate swap market has grown rapidly but most transactions take place in the OTC market. There is a clear need for the Government to develop an exchange-traded derivative market to reduce systemic risk and improve transparency. The experience of Singapore in developing this market would be of interest to Turkey. A vibrant derivatives market will foster the development of risk management products (interest, credit and foreign exchange), which would in turn further deepen the Turkish bond market. In this regard, the ISE needs to be given the space to take an active role to develop derivatives.

G. Credit Rating. The credit rating industry in Turkey is at an early stage of development with mixed quality. The Government needs to carry out an assessment of the local rating agencies, with a view toward raising the standards to the international level. Encouraging local agencies to form joint ventures with international rating agencies would be a solution. Such ventures need to be closely regulated. Mandatory rating can also be considered for public issues of corporate bonds. The experience of East Asian countries (Malaysia and Thailand) has been very successful. This is necessary, at least at the early stage of market development. In Malaysia, the Securities Commission also introduced a recognition system in January 2006 on local credit rating agencies (CRAs), which will serve as a platform to ensure that CRAs exercise high standards of professionalism and due diligence in rating and monitoring corporate bonds and Islamic securities. The recognition system will also provide adequate and timely dissemination of rating information to the investing public. The recognition criteria, place importance on four key factors critical to ensuring the quality and integrity of the rating process: transparency and timeliness of rating disclosure; monitoring and updating process; independence and avoidance of conflict of interest; as well as the adequacy of expertise and resources of the CRAs. CRAs are also required to adopt the International Organization of Securities Commission's Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO CRA Code) and disclose the implementation process of the various provisions of the IOSCO CRA Code. Turkish law does not require debt securities to be rated by an international or domestic credit rating agency. However, where rating is provided, then the rating opinion is required to be part of the prospectus and circular. The CRA is then required to review the rating opinion once a year or regularly if deemed necessary by the CMB. In order to facilitate greater efficiency in the credit rating process, the authorities can consider allowing CRAs to monitor ratings within their internal guidelines, while ensuring that the CRAs operating in the domestic bond markets are subject to strong supervisory oversight according to IOSCO's principles.

H. Regulatory Frameworks.

- The 2001 reforms for the financial sector have established strong and independent regulators for the financial sector. The government instituted extensive legal and regulatory reforms to facilitate the development of a vibrant and robust bond market. Nonetheless, the regulatory response to new products or innovations in the market would appear to be piecemeal in nature, because the capital markets law was not drafted to be sufficiently facilitative for the introduction of new products without releasing a separate communiqué on them. Instead of a piecemeal approach to legal and regulatory reforms, it is time for a holistic and comprehensive review of the capital markets law that can, among other things, facilitate the introduction of new products and respond to innovations, without having to introduce a series of communiqué to deal with them. This would pave the way for a more market-based approach to regulation without compromising on the need to protect the stability and maintain investor confidence.

- The second important issue relates to the need for robust feedback and a consultative mechanism to ensure that changes to the laws that affect the capital markets are properly assessed against the operations of the capital market and market participants. This would include laws like the commercial code and the bankruptcy law as well as laws that govern banks and other non-bank institutions such as insurance companies and pension funds and the tax law. In this regard, there needs to be a high level coordination mechanism within the government that would draw participation from relevant agencies such as the CMB, BRSA, insolvency authorities, etc. to ensure that all laws that affect the capital markets are subject to scrutiny and go through a process of impact assessment before they are enacted as laws.

- Third, an issuance process that provides greater flexibility and time-to-market would enhance efficiency. In this regard, while the shelf program has been introduced for public offerings of corporate bonds, there is still the need for the issuer to seek subsequent approval from the CMB one year after the registration of the master prospectus. This is done because the financial information in prospectus would need to be audited for the next financial year. In other markets, this process is further streamlined for certain categories of "eligible" issuers, so long as the updated financial information is filed with the regulators, thus allowing for better time to market issuances.

- Fourth, effective protection and enforcement of creditors' rights is critical for the bond market. Section 206 of the bankruptcy law deals with bondholders' ranking in terms of priority with other classes of creditors. However, it would seem that there is much confusion and uncertainty as to how these bond holders would rank, as compared to other classes of creditors in the event of insolvency of an issuer. Clearly, there is a need for some clarification so that all participants concerned understand the actual interpretation of the law. The delays in execution of collateral and bankruptcy proceedings as well as in reaching decisions in complex financial

cases may also be issues that need to be addressed. This issue is well recognized by the Turkish authorities, who have represented that effective protection and enforcement of creditors' rights would be a reform that is a part of the Istanbul International Financial Center (IFC-Istanbul) project.

- Corporate bonds that are traded on the ISE are not currently included under the Investors' Protection Fund. To attract both domestic and international investors, the authorities can take immediate action to amend the law to close the gap.

I. Taxation of financial instruments plays an important role in fostering the development of financial markets. Ideally, all financial market instruments need to be subject to the same taxation to create a level playing field. In Turkey, foreign investors are currently subject to zero percent withholding tax on interest income from corporate bonds and zero percent tax on capital gains. Thus far, foreign portfolio investors have not been meaningful investors in corporate bonds as there are no corporate bonds with high credit ratings. There is also practically no liquidity in the domestic corporate bond market. Domestic Investors (residents) are subject to 10 percent withholding tax, and it is the final tax. This is the same as the treatment of interest income from government securities. There is also no capital gain tax from corporate bonds trading similar to the treatment of capital gains from stock investment. Most investors in the existing corporate bonds are overseas Turkish investors. However, interest income earned from bank deposits is currently subject to 15 percent withholding tax, which is substantially higher than withholding tax on government and corporate bonds. The rationale for higher withholding tax is not very clear and it appears to favor investment in GSD that carries lower withholding tax. Harmonization of withholding taxes across all debt instruments will eliminate distortion and create a level playing field. In addition, taxation for issuers should also be looked at.

J. Market infrastructures (trading platform, clearing, settlement and custody). The systems used in clearing, making payments and settling securities trades are crucial for the development of bond markets. Turkey has built a well functioning clearing and settlement system for the securities market. However, to foster secondary market development, highly rated corporate bonds can be accepted as collateral by Takasbank.

K. Risk Mitigation. Developing the corporate bond market has great benefits as well as challenges. There are several risks associated with the corporate bond market. There are risks in both the primary and the secondary markets. In the primary market, the issuance of corporate bonds tends to be on a syndication basis rather than through auction. The issuance size is generally small and infrequent. Investors are going to be unable to make a prudent investment decision without a credit rating by a credible rating agency. Therefore, there is a need to ensure that bonds are properly rated and prized. An efficient primary corporate bond market requires strong and well-funded financial intermediaries. The primary dealers for government bonds can assume this function initially, although syndications are preferred. There are several risks in the secondary market. These include liquidity and credit risks. Corporate bond markets in most countries are not liquid due to the size of the individual issue and frequency of issuance.

In addition, dealers are unable to create a market for corporate bonds due to an absence of funding. Therefore, it is essential that a funding facility is made available to dealers for corporate bonds. A sound regulatory framework needs to be adopted to avoid systemic risks from defaults of corporate bonds, which has happened in several markets. A regulatory framework for bankruptcy and debt restructuring is essential for a vibrant corporate bond market. In a highly developed market, more corporate bond issuance might induce greater capital inflows, which currently pose a macroeconomic challenge. There is a possibility that corporate bonds draw funding from banks, which could worsen loan- to deposit ratios and banks' reliance on wholesale/external funding, and increase volatility of banks' funding. Corporate bond markets also need to factor in macro-prudential supervision. The risks discussed in this section can be mitigated through sound prudential regulations of issuers, dealers, investors and other market intermediaries (credit rating agencies, auditors and lawyers). Efforts in this area need to be harmonized with the BRSA; as with the progression to Basel 3, there will be more efforts on risk based ratings. Given the negligible level of the corporate bond market at the moment, however, these risks are still minimal. However, it is prudent to address them in the nascent stage of the market.

Figure 7.1: Results framework action plan – Corporate Bond Market Development

Challenges	Near Term (2011 -2012)
Build a critical mass for high quality Issuers of corporate bonds	▪ Building a critical mass of high quality or "blue chip" companies to issue bonds in the domestic market to diversify their funding base. ▪ Invite multilateral development banks to issue bonds in TL in local market to broaden the range of high quality products in the corporate bond market. ▪ Amend listing criteria for ISE and the CMB to encourage large blue chip companies to list their bonds on the ISE by providing some form of incentives such as a faster turnaround time for issuance clearance. ▪ Disclose the financial statements of pension funds on a mark-to-market basis.
Create market-making for corporate bonds	▪ Facilitate primary dealers to undertake market making for corporate bonds and amend ISE rules to create a market making system for corporate bonds. ▪ Allow T+2 settlement for corporate bonds in order to facilitate foreign investors.
Develop hedging market	▪ Allow highly-rated corporate bonds to be accepted as collateral for margin under the rules of the ISE. ▪ Develop the exchange traded derivative markets to reduce systemic risk and improve competition by easing entry and exit.

Enhance trading of benchmark bonds for major tenures	▪ Introduce buy-back and conversion operations in a cost-efficient manner to enlarge the issuance size of benchmark bonds. ▪ Increase further the portion of fixed rate bonds in the debt stock to reduce vulnerability to global and domestic shocks.
Broaden investor base with variety of risk and duration preference	▪ Ensure that the benchmark 10-year Government Bonds are fully priced by the private sector participants. ▪ Introduce mandatory rating for corporate bonds.
Create investor protection in case of insolvency	▪ Make clear the ranking of bond holders as compared to other classes of creditors in the event of insolvency of an issuer.
Address distortion in the financial markets created by taxation	▪ Reduce capital gains tax on mutual fund trading in order to align with retail investor and create a level playing field
Reduce investment-savings gap as the availability of domestic savings has not been adequate to meet the funding requirement of corporate sector	▪ Re-examine the private pension space in order to enable growth and competition. The World Bank is working with the authorities in this regard.
Challenges	**Long Term (2013-2018)**
Replace piecemeal and prescriptive approach to regulation	▪ Enact a comprehensive and modern framework for Capital Markets Law so that it would position the Turkish capital markets to facilitate market development and innovations, without compromising on investor confidence and market integrity.

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Annex 1 Private Debt Issuance in Turkey

	Company	Date	Amount Issued (TL)	Type	Public Offering / Private Placement	Maturity	Simple Interest Rate (%)	Compound Interest Rate (%)	Discount Rate (%)
1	Koç Tüketici Finansmanı	July 06	100,000,000	Corporate Bond	Public Offering	2 years	20.16	21.18	n/a
2	Altınyıldız Mensucat ve Konfeksiyon	Sept 06	50,000,000	Corporate Bond	Public Offering	2-3 years (3 series)	22.00	24.70	n/a
3	TEB [1]	July 07	13,210,000	Corporate Bond	Private Placement	No fixed term			n/a
4	Koç Tüketici Finansmanı	July 07	60,000,000	Commercial Paper	Private Placement	540 days	n/a	n/a	19.17
5	Koç Tüketici Finansmanı	Sept 07	65,000,000	Commercial Paper	Private Placement	540 days	n/a	n/a	19.85
6	Koç Tüketici Finansmanı	Dec 07	105,000,000	Commercial Paper	Private Placement	540 days	n/a	n/a	17.90
7	C Faktoring	Dec 07	20,000,000	Corporate Bond	Private Placement	2 years	Floating	Floating	n/a
8	Koç-Fiat Kredi Tüketici	Dec 07	40,000,000	Commercial Paper	Private Placement	540 days	n/a	n/a	17.13
9	Creditwest Faktoring	Mar 08	50,000,000	Corporate Bond	Public Offering	2 years	Floating	Floating (first coupon 20.75)	n/a
10	Koç Tüketici Finansmanı	Sept 08	150,000,000	Corporate Bond	Public Offering	2 years	18.81	19.75	n/a
11	Koç-Fiat Kredi Tüketici	Nov 08	50,000,000	Commercial Paper	Private Placement	540 days	n/a	n/a	n/a
12	Pamuk Faktoring	May 09	20,000,000	Corporate Bond	Private Placement	2 years	n/a	19.00	n/a
13	Koç Tüketici Finansmanı	May 09	50,000,000	Corporate Bond	Private Placement	1.5 years	14.591	15.125	n/a
14	Koç Tüketici Finansmanı	May 09	50,000,000	Commercial Paper	Private Placement	360 days	n/a	n/a	14.74
15	Bankpozitif	Sept 09	50,000,000	Corporate Bond	Private Placement	2 years	12.03	12.39	n/a
16	SGT Sanayi	Sept 09	400,000	Corporate Bond	Private Placement	5 years	20.00	n/a	n/a
17	Pamuk Faktoring	Oct 09	20,000,000	Corporate Bond	Private Placement	2 years	13.30	13.30	n/a
18	Koç Tüketici Finansmanı	Jan 10	30,000,000	Corporate Bond	Private Placement	18 months	9.5183	9.3068	n/a
19	Koç Tüketici Finansmanı	Jan 10	30,000,000	Commercial Paper	Private Placement	360 days	n/a	n/a	8.59
20	Koç-Fiat Kredi Tüketici Fir	Jan 10	50,000,000	Commercial Paper	Private Placement	360 days	n/a	n/a	8.93
21	Akfen Holding	Feb 10	100,000,000	Corporate Bond	Public Offering	2 years	Floating	Floating	n/a
22	Koç-Fiat Kredi Tüketici Fir	Apr 10	80,000,000	Corporate Bond	Private Placement	1 year	n/a	0.85 (spread)	n/a
23	Koç Tüketici Finansmanı	May 10	50,000,000	Corporate Bond	Private Placement	18 months	10.6490	10.3945	n/a
24	Koç Tüketici Finansmanı	May 10	25,000,000	Commercial Paper	Private Placement	360 days	n/a	n/a	9.3715
25	Keskinoğlu Tavukçuluk	May 10	25,000,000	Corporate Bond	Private Placement	2 years	n/a	1.77 (spread)	n/a
26	Keskinoğlu Tavukçuluk	May 10	25,000,000	Corporate Bond	Private Placement	3 years	n/a	1.83 (spread)	n/a
27	Creditwest Faktoring	May 10	100,000,000	Corporate Bond	Public Offering	2 years	Floating	Floating	n/a
28	Lider Faktoring Hizmetleri	June 10	150,000,000	Corporate Bond	Public Offering	2 years	5.70	11.76	n/a
29	Merinos Halı	June 10	50,000,000	Corporate Bond	Public Offering	2 years	3.11	13.11	n/a
30	DD Konut Finansman	July 10	50,000,000	Corporate Bond	Private Placement	3 years	9.92	10.2952	n/a
31	Beyaz Filo Oto Kiralama	July 10	24,900,000	Corporate Bond	Public Offering	3 years	Floating	Floating	n/a
32	Akbank [1]	July 10	1,580,800,000	Corporate Bond	Private Placement	5 years	n/a	n/a	n/a
33	Bimeks Bilgi İşlem ve Dış T	July 10	30,500,000	Corporate Bond	Public Offering	2 years	Floating	Floating	n/a
34	Boyner Büyük Mağazacılık	July 10	40,000,000	Corporate Bond	Private Placement	2 years	Floating	Floating	n/a
35	Arzum Elektrikli Ev Aletler	Aug 10	20,000,000	Corporate Bond	Private Placement	2 years	Floating	Floating	n/a
36	Koç Tüketici Finansmanı	Aug 10	70,000,000	Commercial Paper	Private Placement	2 years	9.3231	9.541	
37	Bankpozitif	Sep 10	100,000,000	Corporate Bond	Public Offering	3 years	Floating	Floating	n/a
38	Koç Tüketici Finansmanı	Oct 10	100,000,000	Corporate Bond	Public Offering	1.5 years	7.9876	7.8243	n/a
39	Ekspo Faktoring	Oct 10	20,000,000	Corporate Bond	Public Offering	2 years	Floating	Floating	n/a
40	Koç Tüketici Finansmanı	Nov 10	100,000,000	Corporate Bond	Public Offering	2 years	7.8489	7.6293	n/a
41	Koç Tüketici Finansmanı	Dec 10	100,000,000	Corporate Bond	Private Placement	2 years	8.5740	8.7583	n/a
42	Akbank	Dec 10	2,500,000,000	Bank Bill	Public Offering	178 years	7.28		n/a
43	Koç-Fiat Kredi Tüketici Fir	Dec 10	50,000,000	Corporate Bond	Private Placement	2 years			
44	Koç-Fiat Kredi Tüketici Fir	Dec 10	50,000,000	Corporate Bond	Private Placement	1-3 years			
45	Akbank T.A.Ş.	Dec 10	1,000,000,000	Bank Bill	Public Offering	178 days	7.28	n/a	n/a
46	Aktif Yatırım Bankası	Dec 10	100,000,000	Bank Bill	Private Placement	360 days	floating		
47	T.Garanti Bankası	Jan 11	3,000,000,000	Bank Bill and/or Corporate Bond	Public Offering	1 year	7.68091	7.97698	n/a
48	Alternatifbank	Jan 11	120,000,000	Bank Bill	Public Offering	178 days	n/a	n/a	

Table on Transaction Costs on Bonds in Turkey (For TL100,000,000 total issue)

No.	Type of transaction costs	Government bonds (private placement/OTC)	Government Bonds (Listed)	Corporate Bonds (private placement/OTC)	Corporate Bonds (Listed)
1	Exchange fee	0	0	(-)	125,000
2	Clearing and depository bank ISIN fee	0	0	320	320
3	Brokerage commission	0	0	(-)	600,000
4	Withholding tax	0	0	0	0
5	Capital gains tax	0	0	0	0
6	Stamp Duty	0	0	0	0
7	Credit rating fee	0	0	(-)	50,000
8	Due diligence costs	0	0	0	15,000
9	Central Registration Agency fee (on issuance)	0	0	1,500	1,500
10	Depository fee (capital)	10,000	10,000	10,000	10,000
11	Depository fee (coupon)	1,000	1.000	1,000	1,000
12	Board registration fee	N/A	N/A	200,000	200,000
13	Official registry fee (gazette)	N/A	N/A	N/A	10,000-50,000
	Total (Approx)				1,032,800

1) Exchange fee = 0.1 % 100,000,000 * 0.1 %= 100,000 TL Exchange fee / 4 (one fourth of exchange fee) → yearly fee of staying quoted 100,000.000 * 0.025 %= 25.000 TL Total = 125.000 TL **2)** It's a fixed amount per ISIN. **3)** On nominal amount %0,60 100,000,000 * 0.60% = 600,000 TL (Using broker is not mandatory for private placements) The cost could be lower for the group companies. **4)** Domestic and foreign institutional investors → 0% Domestic and foreign individual investors → 10% **5)** It's the same as withholding tax info. **7)** Credit rating is not mandatory.	**8)** According to ISE regulations, it is mandatory for issuers to submit a legal report to ISE. Except from this requirement, there is no a comprehensive due diligence process that may be requested by any authorities. Prospectus is prepared by the investment bank. **9)** At first registration of the issuer 20,000 TL. Nominal amount * 0.01% up to 1,500 TL. Yearly amount can not exceed 40,000 TL. 100.000.000 * 0.01% = 10,000 TL **10)** Paid by investors. Nominal * 0.01% (100,000,000 * 0.01% = 10.000 TL) **11)** Paid by investors. Nominal * 0.001% (100,000,000 * 0.001% = 1,000 TL) **12)** It's the maximum amount. Registration fee ratio increases as the maturity lengthens (Min 0.05% and max 0.2%). 100,000,000 * 0.2% = 200,000 TL

Annex 2 Survey Summary

1. **The World Bank Group, in collaboration with the Capital Markets Board of Turkey, carried out a survey among the Turkish Corporate sector to learn more about their current sources of financing and to estimate their interest in the corporate bond issuance.** The majority of 80 companies that completed the survey belong to industrials (manufacturing, 36.3 percent), followed by the financial sector (35 percent), consumer goods (15 percent) and oil & gas (6.3 percent); 92.5 percent of the companies are listed on the stock exchange. Companies were asked to rank their main sources of financing, reasons for using/ not using corporate debt as a financing source, and their interest in issuing bonds, *on a scale of one to seven, where one is the most important.*

Table 0. 1. Sources of Financing

Answer Options	Rating Average
Internal Funds or Retained Earnings	*2.7*
New Equity Issuance	4.3
Loans from Domestic Banks	*2.7*
Loans from Foreign Banks	3.2
Debt Issuance	4.8
Commercial Paper	5.2
Other	5.3

2. **Surveyed companies ranked internal funds (or retained earnings) and loans from domestic banks as their main sources of financing with an average rating of 2.7**. The third most important financing source is loans from foreign banks, with a rating of 3.2. Issued debt and commercial papers are the least significant sources of finance for surveyed companies.

3. **Companies consider the availability of better financing alternatives the main reason for not using corporate bonds as their financing source, giving it an average rating of 2.8.** The second most important reason is the high cost associated with the issuance of corporate bonds, with a rating of 3.5. Burdensome disclosure requirements, paper work, establishing relationship with underwriters and credit agencies, tax issues, pricing difficulties and low secondary trading activity are less important. Other reasons provided by companies include the current legislation for investment trusts which doesn't allow them to borrow for a maturity longer than 365 days, or no need for additional financing.

4. **Balance sheet maturity is the number one reason for using corporate bonds as financing source, with a rating of 2.3**. One of the survey respondents noted that the average maturity of term deposits is only around 30 days, and the average maturity of bank loans is around one year, which makes corporate bonds more attractive. The second next important reason is cost of financing, with a rating of 2.5. It is followed by currency matching (3.1), tax advantages (3.4) and simple regulatory requirements (3.6). Other reasons provided by companies include funding base diversification and support to growth plans, lower rollover risk and easier budget forecasting.

5. **Financial institutions and large-scale industrial manufacturing are among those companies who stated that issued debt is an important financing source.** They listed balance sheet maturity, cost of financing and currency mismatch as critical factors in determining the need for using corporate bonds as their financing source.

Table 0. 2. Reasons for not using corporate bonds

Answer Options	Rating Average
Burdensome Disclosure Requirements	5.9
Excessive Paper Work	5.3
High All in Cost	*3.5*
Establishing Relationship with Underwriter	6.7
Obtaining Ratings	6.2
Availability of Better Financing Alternatives	*2.8*
Unfavorable Tax Treatment	6.1
Lack of Secondary Market Liquidity	5.3
Absence of Benchmark for Pricing	6.3
No Long-Term Project to Finance	6.9
Other	6.0

Table 0. 3. Reasons for using corporate bonds

Answer Options	Rating Average
Balance Sheet Maturity Matching	*2.3*
Relatively Simple Regulatory Requirements	3.6
Tax Advantages	3.4
Cost of Financing	*2.5*
Currency Matching	*3.1*
Others	3.5

6. **More than half of the companies surveyed indicated they planned on issuing bonds in the future.**

Annex 3 Corporate Bond Markets in Selected Emerging Market Countries (Brazil, Malaysia, South Korea, Thailand and South Africa)

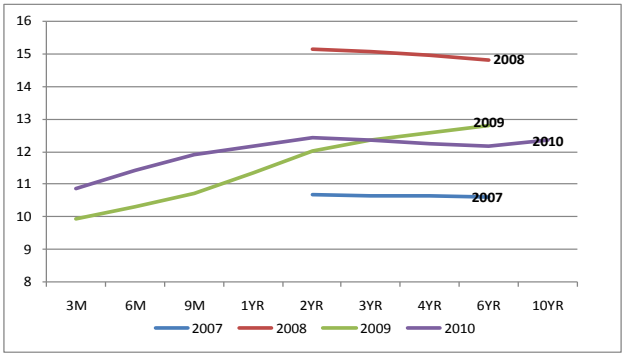
Brazil

Introduction

1. Brazil has a large local currency bond market. In 2009, the total size of the local currency bond market was US$1.2 trillion, or 78.6 percent of GDP. The Brazilian bond market is relatively large and liquid for an emerging market country. The growth of the domestic bond market has largely been driven by strong macroeconomic fundamentals, which have enabled Brazil to restructure its public debt profile, decrease the share of foreign and floating rate debt, and extend the local currency sovereign yield curve in an environment of lower interest rates. In addition, Brazil has been successful in building a domestic investors' base. The local mutual fund industry, pension funds and insurance companies have grown substantially. This has made it possible for the Government and the corporate sector to raise funds in the domestic bond market.

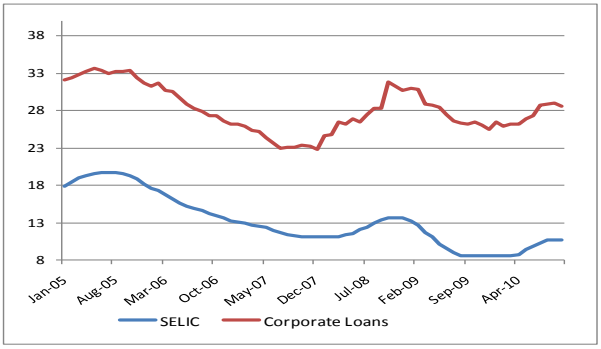
2. The size of the corporate bond market (financial institutions and non-financial corporations) at the end of 2009 was US$433.6 billion, or 34.7 percent of total. However, most issuers were financial institutions. In addition, attractive sovereign yields and high rollover requirements for government bonds continue to crowd out medium and small corporations. The availability of long-term corporate loans on concessionary terms through state owned banks (e.g. BNDES) has somewhat reduced incentives for some companies to tap the domestic market. The Government has recently recognized this distortion and announced a serious of measures to encourage the development of the corporate bond market and decrease the role of state banks in providing long term financing (Box A. 1).

Figure A. 1: Evolution of Brazilian Sovereign Yield Curve



Source: Bloomberg

Figure A. 2: Evolution of Interest Rates

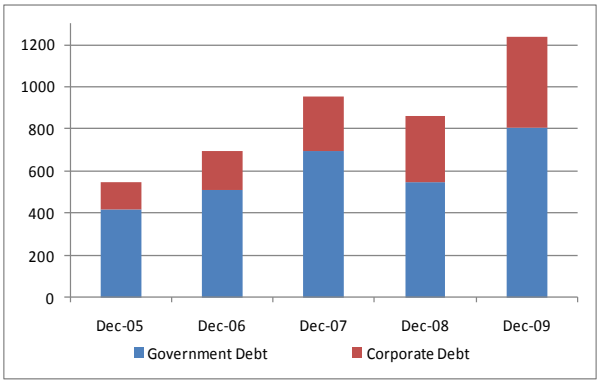


Source: BCB – Depec

Local Debt Market: Issuers and depth of the market

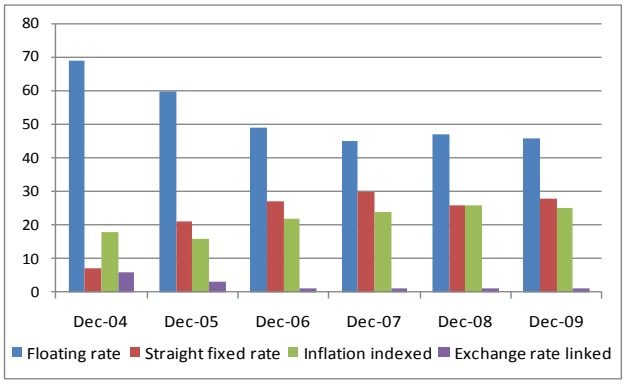
3. Figure A. 3 shows the outstanding amount of local debt in Brazil by class of issuers from 2005 until 2009. Although the Government remains the biggest issuer by large, the share of corporate bonds has increased in the total amount of outstanding debt. The National Treasury (NT) seeks the extension of the average life of public debt (Figure A. 1) and an increasing share of fixed-rate bonds in its composition (it increased from 7 percent at end-2004 to 28 percent at end-2009). This will help further lengthen benchmark interest rates in the market.

Figure A. 3: Outstanding Debt by Issuer (USD billions)



Source: BIS

Figure A. 4:Composition of Bonds by Instruments (%)



Source: BIS

4. Although the local currency sovereign yield curve has been extended over the years, the liquidity remains concentrated in its shorter end. The large portion of non-government issued bonds, as well as the investment industry performance, tend to be indexed to CDI (interbank overnight rate). DI futures (CDI derivatives) are still the most liquid instrument in the fixed income market. Liquidity is very low in the corporate bond segment.

Investors' Base

5. Mutual funds are the largest institutional investors in Brazil, in terms of their assets under management. At the end of 2009, the size of the mutual fund industry was US$838.6 billion, or 46 percent of GDP. The private pension system, with assets under management of US$295 billion (16 percent of GDP) by December 2009,[13] encompasses open and closed pension funds. The open pension funds have been growing, but from a smaller base, while the closed pension funds are already experiencing net outflows.[14] Pension funds have limitations on overseas investment. Therefore, they have invested most of their assets in the local market. The size of the insurance industry was US$37 billion, or 1.2 percent of GDP, at end-2009, with the life-insurance segment comprising 55 percent[15]. JP Morgan estimated that foreign ownership accounted for about 10 percent of the local public debt[16] in 2009. No estimates are available for their holdings of the local corporate debt, but it is likely to be negligible, given the low liquidity.

13 JP Morgan, "Latin America Pension Funds Report", 2010.
[14] JPMorgan, "Local Markets Guide", November 2009.
[15] Axco Global Statistics.
[16] JPMorgan, "Local Markets Guide", November 2009.

Table A. 1: Asset Allocation of Investors

Asset Allocation of private pension funds, Nov 2009

	R$ billlion	%
Government Debt	82	19.3
Cash	n/a	n/a
Shares	119.6	28.1
Inv. Funds	199.8	46.9
Other assets	24.4	5.7

Source: JPMorgan, "Local Markets Guide", Nov 2009

Asset Allocation of mutual funds, Sep 2010

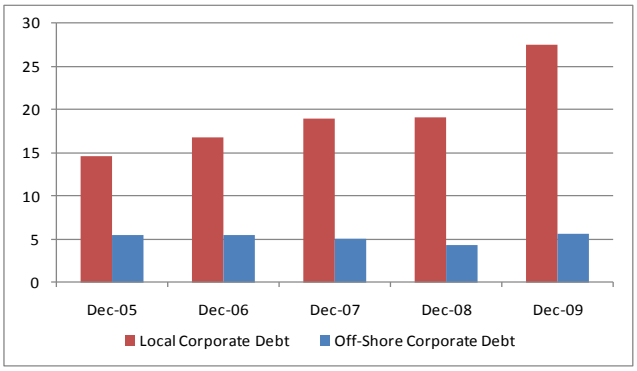
	R$ billlion	%
Repo	362.3	22.1
Treasuries	644.4	39.4
Private Debt	334.8	20.4
Equity	296.1	18.1
Total	1,637.6	

Source: Andima

Corporate Debt Market

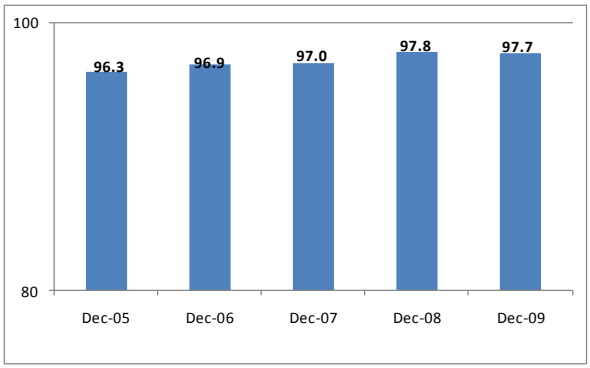
6. Despite growth in recent years, the local corporate debt market remains small in Brazil. Largely, this is because interest rates are still high, making it very expensive for local corporations to issue debt domestically. Corporations often find it more attractive to leverage themselves abroad, although proportionally less so lately (Figure A. 5), or by selling equity as witnessed by the large number of initial public offerings in the last several years. Similar to many emerging markets, the private corporate debt market is not diversified, with a large proportion of financial institutions' debt in the total corporate debt (Figure A. 6). Another constraint to market development are the small sizes of issuances which result in poor liquidity of corporate bonds, making them less attractive to investors. In addition, the crowding out effect of the government debt seems to be significant in Brazil. Since local corporate bonds are currently trading with a relatively small premium to the sovereign curve – and because of the associated credit, liquidity and interest rate risk (as well as the tax issues for foreign investors) – it does not make much sense for investors to devote a large portion of their assets to this investment class.

Figure A. 5: Corporate Debt (% of GDP)



Source: BIS

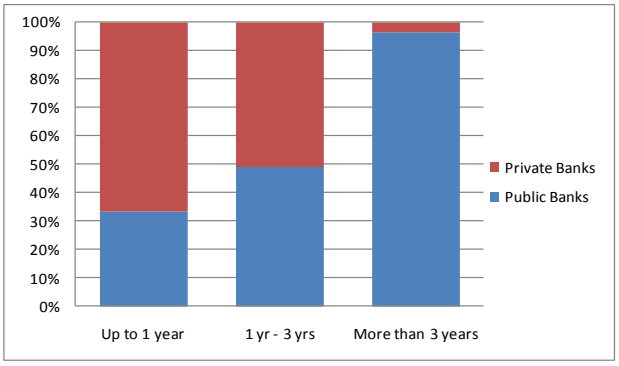
Figure A. 6: Share of FIs in Corporate Debt (%)



Source: BIS

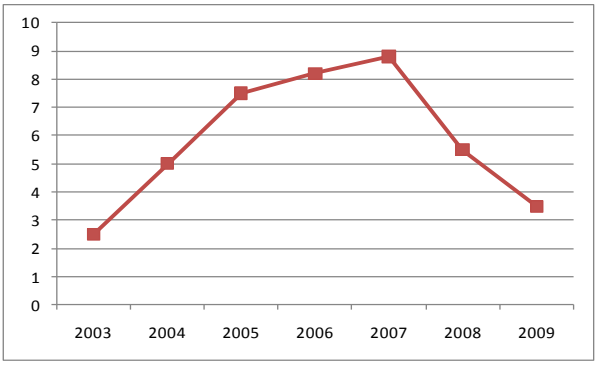
7. Other constraints to market development include: (i) availability of long-term corporate loans at favorable rates and maturities through state owned banks (e.g. BNDES); and (ii) high issuance costs[17]. In fact, the central bank's data suggest that the maturity of loans extended by public banks is much higher compared to the maturity of the loans extended by private banks. Given that BNDES has a 20 percent share of the total banking system, and its sources of financing include direct transfers from government and earmarked taxes, it is a major distortion in the market for long-term financing.

Figure A. 7: Term Structure of Loans by the Type of Bank



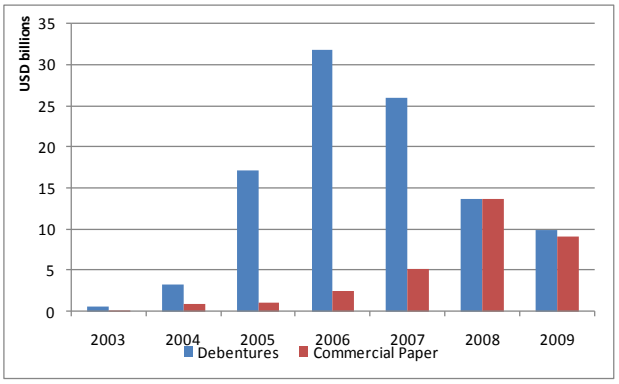
Source: BCB

Figure A. 8: Average Maturity of Debentures (yrs)



Source: Andima

Figure A. 9: Structure of Corporate Debt



Source: Andima, Debentures = corporate bonds

8. Although private corporate securities in Brazil are generally of a short-term nature, data published by Andima suggests that the average maturity of corporate bonds has been increasing in the period preceding the global financial crisis, in line with declining interest rates and credit expansion, reaching the peak of 8.8 years in 2007 (Figure A. 8). Bond maturity has decreased dramatically since then. In addition, the share of bonds in total corporate debt market has decreased in favor of short-term instruments, such as commercial paper (Figure A. 9). Most bonds have floating interest rates, with a spread set over the CDI. Inflation-adjusted corporate bonds are also commonly issued.[18]

[17] Corporate bond issuing costs include registration fees (CVM and others), publication costs, rating, and fees for other services, such as legal etc, besides underwriting fees. For issues by special purpose entities, there are other costs related to due diligence and financial feasibility studies.

[18] This discussion of the features of a corporate bond market is based on several sources including: Andima monthly market overviews, Oct, Nov 2009; PIMCO Market discussions, February 2010, Leal and Carvalhal-da-Silva, "The Development of the Brazilian Bond Market", 2006; and World Bank "PCN - Brazil—Non-Lending Technical Assistance (NLTA) on Developing the Long-Term Capital Markets", 2010.

Regulatory Framework

9. The regulatory environment for Brazilian capital markets was set up in 1976, with the introduction of the law that created the Securities Commission (CVM). The Law mandated the CVM to regulate and supervise the stock and corporate bond markets. In the same year, the new corporate law was introduced. Despite some recent changes, it still is the basis of Brazilian corporate law and defines numerous aspects of investor protection, such as disclosure, auditing, corporate governance, securities issuance etc. Closed and open retirement funds were created and regulated by a 1977 law. In the late 90s, the supervision power of the CVM was strengthened, and new rules were introduced in the corporate law to improve transparency and investor protection.

Credit Rating

10. Major international credit rating agencies are present in Brazil, including Moody's, Fitch and S&P. There are also smaller local players, such as Austin Rating, SR rating and LF Rating (whose ratings are widely used for domestic issuance). A credit rating is required for corporations to issue bonds in the local market.

Market Infrastructure (Trading, Clearing & Settlement)

11. Corporate bonds in Brazil are issued through public offerings and private placement. The secondary trading of these instruments is limited, and they are mainly traded over-the-counter. They are also traded on the National Debentures System (SND, "Sistema Nacional de Debêntures") and on Bovespa Fix. The National Debenture System is an electronic secondary market for debentures in Brazil created in 1988 and maintained by the National Association of Financial Institutions (ANDIMA). Bovespa Fix is an integrated framework for the trading, settlement and safekeeping of corporate bonds launched in 2001 by the São Paulo Stock Exchange (Bovespa) and CBLM (Brazilian Clearing and Depository Corporation). Bond custodial and settlement services are performed through either the SND or the Bovespa Fix systems. The settlement of transactions occurs on the trade date, T+0 or T+1.

Derivatives

12. The market for fixed income derivatives is large in Brazil and, according to Andima, it comprised 39 percent of the total fixed income market in October 2009. DI futures (fixed maturity date contracts on the CDI) are the most liquid fixed income instruments in Brazil, with a volume of trading larger than that of government bonds. There is also a big swaps market (the most common being CDI versus fixed rate, CDI versus inflation index and CDI versus USD)[19].

Taxation

13. Taxes levied on bonds include: withholding income tax on income earned from investments in bonds; and a financial transactions tax (IOF[20]) for foreign investments in fixed income. The IOF tax has recently been increased from 4 to 6 percent in order to slow down the

[19] JPMorgan, "Local Markets Guide", November 2009.
[20] Tax on foreign currency inflows.

large capital inflows. Foreign investors are exempt from income tax on investments in government bonds. There is no withholding tax for institutional investors. The way the income tax is applied on interest payments has been one of the impediments to market development. Currently tax is entirely paid by the holder of the bond. This was not a problem when the market was virtually exclusive to institutional investors because they do not withhold income tax. However, as more individuals and corporations trade directly in the market, this is an impediment to market growth."[21]

Box A. 1: The Government measures to boost the development of the corporate bond market

Brazil's Minister of Finance announced a package of measures to encourage the development of the corporate bond market and decrease the role of state owned banks (December 16, 2010). Some of the measures will be enforced immediately, while others require Congress' approval.

1. Income tax measures: Individuals and foreign investors will no longer pay income tax on the earning from investments into corporate bonds, with maturities longer than four years intended to finance infrastructure projects. This tax will be reduced to 15 percent for corporations.

2. Measures to increase liquidity:
   a) A privately managed fund will be created to support market-making activities to provide liquidity to the secondary market. The fund will be financed using up to 3 percent of the mandatory banks' reserves.
   b) BNDES will set aside R$ 10 billion (US$ 5.8 billion) to purchase long-term debt issued by corporations.
   c) The transaction tax will be eliminated on the short-term transaction (less than 30 days).

3. BNDES will be allowed to finance itself in the bond market, instead of relying on the funding from Treasury.

[21] Leal and Carvalhal-da-Silva, "The Development of the Brazilian Bond Market", 2006.

Malaysia

Introduction

14. Malaysia has one of the most advanced bond markets among emerging market countries. It is now the third largest bond market in Asia (ex-Japan), after China and South Korea. The Malaysian bond market grew rapidly after the 1997 Asian financial crisis. The crisis was brought about by the mismatch in currency and maturity of borrowing by the corporate sector. The corporate sector was also highly dependent of the banking sector. Concerted efforts were made by the authorities to develop a corporate bond market to provide a viable funding source for the corporate sector and to reduce dependence on the banking sector. In addition, countries in Asia launched the Asian Bond Market Initiatives to develop bond markets in ASEAN +3 countries. Major reforms were carried out on all fronts including: further development of the government bond market; modification in the regulatory framework for regulating private debt securities; introduction of Islamic financial instruments, especially Sukuk (Islamic bond); measures to enhance liquidity in the secondary market for Government and corporate bonds; market-based accounting that is marked to market for debt instruments; introduction of a bond pricing company; and tax incentives to make the local bond market a preferred choice for corporations to raise funds. The large and growing investor base facilitated the development of a bond market in Malaysia. Overall, the Government efforts have been highly successful.

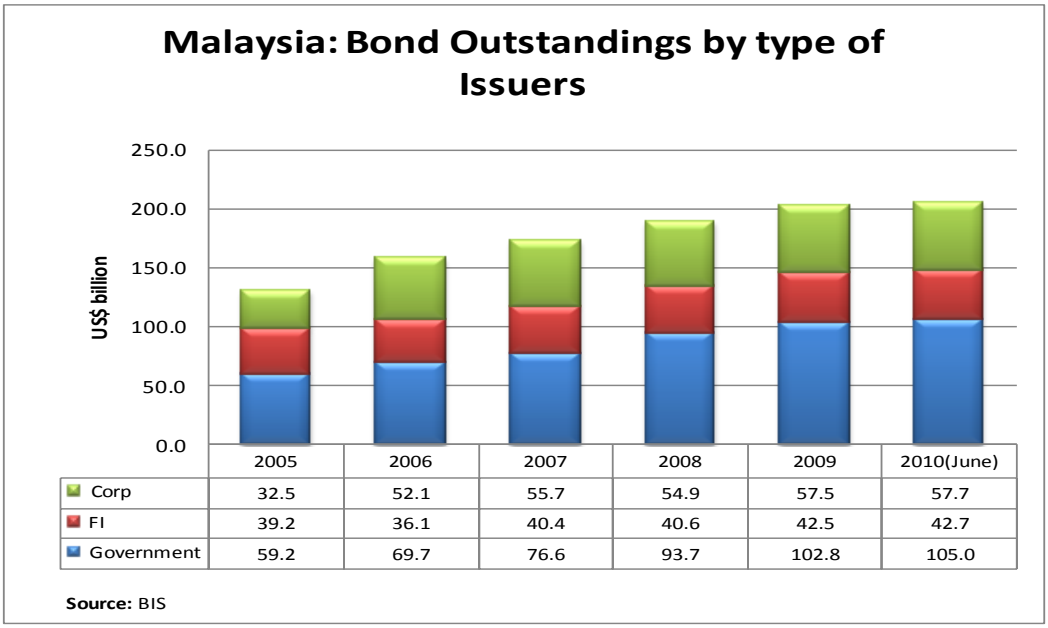
The Bond Market

15. At the end of 2009, the size of the Malaysian bond market was US$202.8 billion (Figure B. 1), consisting of government bonds (50.7 percent), non-financial corporate bonds (28.3 percent), and financial institution bonds (21 percent). If the financial institutions and non-financial corporate are combined then the corporate bond size is 49.3 percent. The size of the corporate bond market has increased from US$77.1 billion in 2005 to US$100 billion in 2009 (BIS). The issuance by non-financial corporations increased from US$32.5 billion in 2005 to US$57.5 billion in 2009. Malaysia has also become the major Islamic capital market and the largest and most innovative sukuk market.[22]

16. The Malaysian debt securities market offers a broad range of instruments, from short-term commercial papers to medium-term notes and long-term corporate bonds of up to 30 years maturity (Box B. 1). The Government, quasi-government entities and publicly listed companies issue debt securities. A unique feature of the Malaysian debt securities market is the existence of a parallel universe of sukuk, or Islamic bonds, side by side with conventional debt. The availability of a broad range of debt instruments has created a range of market participants, both domestic and foreign. In 2005, the Government permitted the multilateral banks and foreign corporations to issue ringgit denominated papers in domestic markets. Furthermore, in 2007, the government issued foreign currency denominated bonds in the domestic market. These measures have enticed many foreign corporations, multinational corporations and multilateral organizations to raise funds and originate transactions out of Malaysia.

[22] Malaysian Debt Securities and Sukuk Market-A Guide for Issuers and Investors, 2009, BNM and Securities Commission Malaysia.

Figure B. 1: Malaysia: Bonds Outstanding by type of Issuers

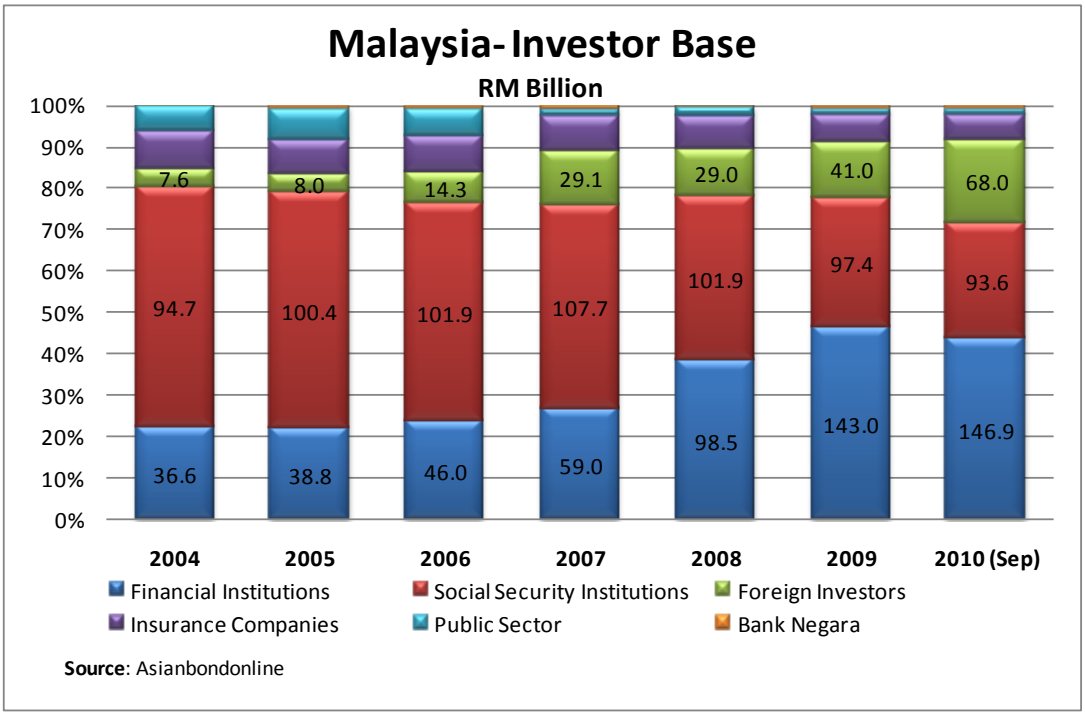


	2005	2006	2007	2008	2009	2010(June)
Corp	32.5	52.1	55.7	54.9	57.5	57.7
FI	39.2	36.1	40.4	40.6	42.5	42.7
Government	59.2	69.7	76.6	93.7	102.8	105.0

The Investor Base

17. Malaysia has a large and diversified investor base. At the end of 2009, the size of the investor base was MR308.3 billion (US$90.1 billion), or 47.1 percent of GDP (Figure B. 2). The contractual savings sector, that includes the Employee Provident Fund, accounted for 58 percent of the investor base in 2004. The EPF is one of the largest funds in the world. However, the contractual savings sector's share has steadily declined due to the increase in the share of financial institutions that rose from 20 percent in 2004 to 46.4 percent in 2009. The share of foreign investors rose from 4.6 percent to 13.3 percent during the same period. The Government has supported the large investor base over the last three decades, and it has greatly facilitated the development of Malaysia's bond market.

Figure B. 2: Malaysia-Investor Base



Market Infrastructures

18. Malaysia has built efficient market infrastructures for both primary and secondary markets. In the primary market, auctions and other primary market transactions are conducted through Fully Automated System for Issuing/Tendering (FAST), which is an electronic platform operated by the BNM. The clearing and settlements of bond market transactions are performed through Real Time Electronic Transfer of Funds and Securities System (RENTAS), which is also operated by the BNM. In August 2008, an Electronic Trading Platform (ETP) for the Malaysian bond market had been launched by Bursa Malaysia, the stock exchange, to create a single electronic trade reporting and trading platform for the domestic bond market. The ETP is based on the system used by the Korean Exchange and modified to the Malaysian condition. The ETP is a wholly owned subsidiary of Bursa Malaysia. The ETP requires mandatory reporting of all secondary bond market transactions by taking over the function from the Bond Information Dissemination system, which was operated by Bank Negara Malaysia. It is an electronic order-matching platform for the matching of bid and ask quotes for MGS, GII and corporate issues. The platform can also be used by dealers to advertise and negotiate for 'one-to-one' deals for all debt securities and sukuk. The trading platform is expected to enhance price transparency and liquidity in the secondary bond market as well as increase efficiency in the secondary trading activities.

Regulatory Framework for Bond Market

19. Malaysia has a very well defined regulatory framework for financial and capital markets. The Capital Markets and Services Act 2007 is the law governing trading and dealing in securities, including government securities. The Bank Negara Malaysia (BNM) is the main regulator of the financial markets in Malaysia. The primary dealers are licensed and regulated by

Bank Negara Malaysia. Besides the primary dealers, commercial banks and Islamic banks, investment banks are also participants in the inter-bank market for government securities. The Malaysian Code of Conduct for Principals and Brokers in the Wholesale Money and Foreign Exchange Markets sets out best market practices, principles and standards to be observed in the Malaysian market. In addition, BNM also issues rules and guidelines governing the issuance, allotment, interest payment, redemption and settlement of script-less securities under FAST, and RENTAS.

20. On July 1, 2000, the Securities Commission Malaysia (SC) became the single regulator for the Malaysian corporate debt securities and corporate sukuk market and moved towards a full disclosure-based regulatory regime, with the issuance of the Guidelines on the Offering of Private Debt Securities. This was followed by the issuance of the Guidelines on the Offering of Islamic Securities. The SC administers the Capital Markets and Services Act 2007, which governs a substantial part of the activities in the domestic corporate debt securities and corporate sukuk market. The SC issues guidelines on the issuance of corporate debt securities and corporate sukuk, supervises trading activities in the secondary market, and conducts joint examinations and inspections of investment banks together with BNM.

Rating Agencies

21. The Rating Agency Malaysia Berhad (RAM) and the Malaysian Rating Corporation Berhad (MARC) are the domestic credit rating agencies in Malaysia that issue ratings on debt instruments issued in the Malaysian market. RAM was set up in 1990, and MARC was created in 1995. Both organizations were promoted by BNM. Mandatory rating is required for all debt securities and sukuk issues in Malaysia. This has facilitated development of the bond market as it enables a large number of investors to invest in debt instruments. Credit ratings in Malaysia focus on individual issues rather than the credit rating of the corporation. Thus, a corporate can be assigned different rating categories for different issues. Malaysia also requires the recognition of credit rating agencies for the purpose of rating a bond or sukuk issue. CRAs are required to be recognized by the SC for the purpose of rating debt or sukuk issues pursuant to the Guidelines on Recognition of Credit Rating Agencies by the Securities Commission for the Purpose of Rating Bond Issues. A domestic rating agency is also required to adopt the IOSCO Credit Rating Agency Code in its own code of conduct, and to disclose this on its website.

Taxation

22. The tax system in Malaysia is very friendly to investors both domestic and international. Several tax incentives are offered to issuers and investors to develop the domestic bond market.

Issuers: Issuers are offered following incentives:

1) Issuance for PD are exempted from stamp duty;
2) Tax deductions on expenses incurred in the issuance of sukuk;
3) All instruments for the purpose of securitization approved by the SC are exempted from stamp duty; and
4) All instruments for the purpose of a sukuk issuance approved by the SC are exempted from stamp duty.

Domestic Investors: Resident investors are offered the following incentives:

1) Exemption on interest income from ringgit-denominated debt securities and sukuk;
2) Resident investors are exempted from payment of income tax on the profits received from foreign currency-denominated sukuk issued in Malaysia; and
3) There is also no capital gain tax in Malaysia.

Foreign Investors: Foreign investors are exempted from:

1) Income tax on interest income and profits earned from ringgit denominated sovereign bonds, as well as PDS and sukuk approved by the SC;
2) Non-resident investors are also exempted from withholding tax on interest income and profit earned from ringgit-denominated debt securities issued by the Malaysian Government as well as PDS or sukuk approved by the SC;
3) Exemption on interest income from foreign currency-denominated sukuk;
4) Profits or income from non-residents' investments in foreign currency denominated sukuk issued in Malaysia are fully exempted from withholding tax; and
5) There is no capital gain tax in Malaysia.

Financial Guarantee Institution (Credit Enhancement)

23. To enable companies with lower than investment grade bonds to access the domestic bond market, the Malaysian Government recently established the Danajamin Nasional Berhad as a financial guarantee institution. The main objective of Danajamin is to provide credit enhancement for companies wishing to raise funds from the bond market. A financial guarantee institution adequately capitalized can help increase the credit rating of bond issues from below investment grade to investment grade, thereby making the bonds eligible for investment by institutional investors. The guarantee institution will charge a premium commensurate with the perceived risk of the issuer, for guaranteeing to pay the interest and capital repayment in the event of default by the issuer.

Box B. 1: Types of Debt Securities in the Ringgit Bond Market

Malaysian Government Securities (MGS) are coupon bearing long-term bonds issued by the Government of Malaysia. These produce the risk-free interest rate benchmarks for pricing long-term debt securities and are issued according to the Government Securities Auction Calendar, which is updated from time to time depending on the Government's financing needs. MGS are issued by way of tender through principal dealers or via private placement to selected institutions approved by the Ministry of Finance. For new issues issued via tender, submission of bids is on a yield basis and the coupon is market-determined based on the weighted average of the successful yield of the issue. It is payable semi-annually.

Malaysian Treasury Bills (MTBs) are short-term government securities issued by the Government of Malaysia. Similar to Bank Negara Malaysia Bills, MTBs are issued on a discount basis. Holders are paid the nominal amount on the maturity date. In the primary market, MTBs are issued through weekly tenders via principal dealers. In the secondary market, MTBs are also classified into band trading.

Government Investment Issues (GIIs) are government bonds issued under the Government Investment Act, 1983, based on Islamic principles. In the past, GIIs were issued under the concept of *Qardhul Hasan* (benevolent loan). Currently, the issues of GIIs are under the concept of *Bai' Al-Inah.* GIIs are non-interest bearing government bills that enable the participating institutions to meet their liquidity requirements according to Islamic principles. In the primary issue, submissions of tenders are channeled through Islamic banks and principal dealers.

Bank Negara Malaysia Bills (BNBs) are short-term securities with maturities not exceeding one year issued by BNM. For its short-term money market operations, BNB issues are offered to principal dealers through competitive auction. The yield bid is specified as a discount rate and expressed in three decimal places. The tenors of BNB are expressed in actual number of days. BNBs are classified into band trading according to the number of days remaining to maturity for trading purposes.

Bank Negara Negotiable Notes (BNNNs) are Islamic short-term securities issued by BNM with maturities not exceeding one year. The issuance of BNNNs will be based on the principle of *Bai'Al-Inah*. In the primary issue, tenders for BNNNs will be submitted on the exact purchase price (proceeds) basis, through Islamic banks and principal dealers.

Cagamas (National Mortgage Corporation) Instruments:

Floating Rate Bonds. These bonds are of medium/long-term tenor with an adjustable coupon rate. The interest is payable either semi-annually or on a quarterly basis.

Fixed Rate Bonds. These bonds are fixed coupon medium-/long-term bonds where the interest is payable semi-annually.

Cagamas Notes. These notes are short-term securities with a tenor of 12 months or less. The notes are similar to MTBs and normally issued at a discount.

Islamic Notes-Al Mudharabah. These debt securities are of medium-term tenor issued under the Islamic principle of Al Mudharabah, with a pre-determined profit-sharing ratio.

Commercial Papers (CPs) are short-term revolving promissory notes, with a tenor not exceeding one year. The mode of issue of CPs can either be on private placement and/or tender.

Medium-Term Notes (MTNs) are instruments with a tenor of more than one year. This instrument is

an alternative to short-term financing in the CP market and long-term borrowing in the corporate bond market. The mode of offering MTNs in the primary market can either be on private placement and/or by way of tender. If issued on tender, the tender basis can be on yield, price, or exact purchase price depending on the structure of the approved MTN.

Corporate Bonds are long-term scripless securities (conventional or Islamic), which can be interest bearing, profit-based or discounted instruments (e.g., zero coupon), with a tenor of more than one year. The interest-bearing bond and profit-based bond may have a fixed coupon rate or floating coupon rate depending on the structure of the approved facility. For zero-coupon bonds, the securities are issued at a discount without any periodic interest/coupon, and the final redemption is equal to par/nominal value. The issuance of bonds can be privately placed to several investors, on a bought deal basis to a single primary subscriber or tendered to the Tender Panel Member identified by the lead arranger. If issued on tender, the tender basis can be on yield, price, or exact purchase price depending on the structure of the approved corporate bonds.

Khazanah Bonds. Khazanah bonds are issued by Khazanah Nasional Berhad, an investment arm of the Government. They are long-term zero coupon bonds issued based on the Islamic principle of *Murabahah*. The issuance of Khazanah bonds is auctioned on competitive basis via the principal dealer's network. Submission of bids is on price/100 basis.

Combination CPs/MTN Program. The combination CPs/MTN program allows the issuer to invite tender on both CP and MTN simultaneously without breaching the approved facility limit. The issuer will then have the flexibility to draw down CP, MTN, or a combination of both subject to the available facility limit. The mode of offer for CP/MTN can be on tender and/or private placement.

Asset-Backed Securities (ABS) is a form of debt securities (that are backed by specific underlying assets) issued pursuant to a fund-raising process of asset securitization.

Stocks/Loan Notes. These instruments are hybrid debt securities that can be redeemable/irredeemable and/or convertible/nonconvertible into shares. The tradability and conversion feature of these instruments in the secondary market is dependent on the terms and conditions of its approved structure.

South Korea

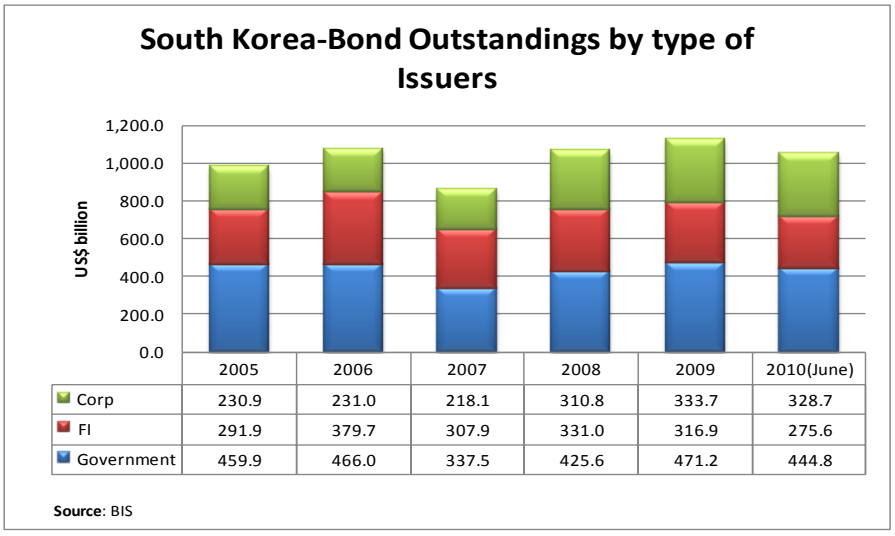
Introduction

24. Korea is now the 11th largest bond market in the world. A wide-range of policy reforms and restructuring of financial and corporate sectors carried out post-1997 has been highly successful in turning around the economy and financial market. This has contributed to the development of one of the largest and liquid bond markets in the world. Although the Korean bond market accounted for only two percent of the world domestic bond market at the end of 2009, as a percentage of GDP, Korea's bond market ranked number five after Japan, USA, Italy and Spain. The Korean bond market is one of the most diversified bond markets and gaining maturity and sophistication.

The Bond Market

25. At the end of December 31, 2009, the size of its local currency bond market was US$1.1 trillion (Figure C. 1). The government bond segment was the largest accounting for 39.9 percent, followed by financial institutions (31 percent) and non-bank corporate (29.1 percent). The growth of the Korean bond market has been dramatic since 1997 when the Government issued a large amount of government securities to recapitalize banks and restructure the corporate sector, which had suffered massive losses following the major devaluation of the Thai Baht in 1997. The Government's policy reforms were highly successful, and the Korean economy fully recovered. The robust government bond market has facilitated the development of a large corporate bond market, liquid derivative markets, and a well-diversified financial market that is comparable to developed countries.

Figure C. 1: South Korea-Bonds Outstanding by type of Issuers



	2005	2006	2007	2008	2009	2010(June)
Corp	230.9	231.0	218.1	310.8	333.7	328.7
FI	291.9	379.7	307.9	331.0	316.9	275.6
Government	459.9	466.0	337.5	425.6	471.2	444.8

Source: BIS

26. The bond markets of the three largest emerging markets (Brazil, China and India) were much smaller than Korea relative to GDP at the end of 2009. Most emerging local currency bond markets consist mainly of government bond markets, with very small corporate bond market. The only exceptions are Malaysia and Thailand that have well-developed and diversified bond markets comparable to Korea. It is interesting to note that the Malaysian

corporate bond market is more robust than the Korean corporate bond market, due to large Malaysian corporations that are rated AAA by local rating agencies. The Korean corporate bond market initially started as a market for SMEs with relatively low credit rating.

27. The government bond market consists of the Korean Treasury Bonds (KTBs), which are issued in maturity ranging from one to 20 years[23]. Bonds are auctioned through a network of primary dealers similar to the system used in the USA. Three-year KTBs account for about 30 percent of the issue. However, the five-year issue is also gaining in popularity with the availability of five-year KTB futures. Ten year KTBs are still relatively illiquid. A 10 year-KTB futures contract was introduced in February 2008 to enhance liquidity in the KTB market at a longer end of the yield curve. The Government does not currently issue treasury bills. As a result, the Korean bond market is deprived of a liquid short-term interest rate benchmark.

28. In addition to the Government, the Bank of Korea (BOK) is a major player in the bond market. It issues Monetary Stabilization Bonds (MSBs) for its conduct of monetary policy. Issuance of MBSs has increased dramatically since 2002, in response to a sharp increase in foreign exchange reserves brought about by improving current accounts and the attractiveness of Korean capital markets to foreign portfolio investors.

29. The corporate bond market in Korea is also relatively less liquid in comparison to KTB and MSB markets. The liquidity for Asset-Backed Securities (ABS) and mortgage-backed securities (MBS) is extremely limited and has created valuation problems for bond pricing companies and investors in fixed income markets. The Government has addressed this problem through the establishment of three bond-pricing companies in 2000 that provide pricing of all bonds on a daily basis to enable market participants and investors to properly value less liquid securities.

30. The large Korean companies now have relatively easy access to international financial markets and with all in cost lower than issuing bonds in the local market. Major issuers in the domestic bond market are the financial institutions. Small-and medium-sized companies are considered too risky for investors and, therefore, are shut out from domestic markets.

31. Korea has been highly successful in developing its derivatives market. A wide range of derivatives are listed on the Korea Exchange (KRX) ranging from futures and options on the KOSPI 200 index, interest derivatives and commodity derivatives. In 2009, KRX was the world's largest derivatives exchange according to the Future Industry Association. It was only second to the Chicago Mercantile Exchange. Since the Korea Futures Exchange (KOFEX) started operations in February 1999, a number of interest rate risk manangement products have been introduced at the exchange and OTC. These include: futures and futures options on KTB securities, CD interest rate futures, futures on 364-day MSBs, interest and cross-currency swaps. Three- and five-year KTB futures contracts have been introduced. In March 2008, the Government introduced 10-year bond futures contract to be traded on the KRX, aiming at further improving liquidity. The most actively traded KTB futures contract is the three-year KTB contract.

[23] The first 20 year KTBs of KW 500 billion were auctioned on March 24, 2006.

Investor Base

32. Since 1997, Korea has made concerted efforts to develop a **domestic institutional investor base**. The rapid development of government controlled contractual saving institutions (National Pension Services and other pension funds), and insurance companies, has created a solid investor base for the bond market. At the end of 2009, the size of the investor base was KW 420.2 trillion (Table C. 1). The largest domestic investor is the National Pension Services (NPS). NPS has thus far been quite conservative, and most funds have been invested in fixed income securities mainly government bonds. Investment in corporate bond has been less than five percent. The insurance industry is the second largest investor in Korea and has grown rapidly. In Malaysia, the EPF has been more active in the corporate bond market, especially in infrastructure bonds. Therefore, there is substantial room for additional investment by NPS in corporate bonds, without increasing its overall risk profile.

Table C. 1: Korea-Investor Base

	Korea- Investor Base						
	(KW billions)						
	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010(June)**
Contractual savings institutions	57,206	66,625	75,976	78,879	81,946	94,282	102,242
Government	64,849	80,019	88,207	88,493	110,473	126,599	124,421
Banks	68,388	72,535	77,085	71,317	76,401	83,201	86,891
Central Bank	2,941	5,342	8,102	10,586	11,992	12,907	13,852
Others	61,212	58,254	63,338	74,810	77,663	103,291	131,562
Total	254,596	282,775	312,708	324,085	358,475	420,280	458,968
_____							
Source: Asianbondonline							

33. The Korean bond market is open to foreign investors. Other major markets, especially China and India, have imposed quantitative restrictions on foreign portfolio investment in domestic bond markets. This was the case in Korea prior to 1997. Foreign portfolio investment in the Korean bond market has increased sharply since 2005 and accounted for seven percent of market capitalization at the end of 2009. Foreign investors were exempted from withholding tax of 14 percent on interest income from government bonds. However, in December 2010, the Government withdrew this exemption to reduce systemic risks to the Korean economy for abrupt withdrawal of fixed income investors.

Regulatory Frameworks

34. Prior to April 1998, the Ministry of Finance and Economy (MOFE)[24] had the ultimate power to control all facets of the financial system. The MOFE was a very powerful ministry in Korea before it relinquished some of its important functions to the Financial Supervisory Commission (FSC). Until then, the MOFE established basic policies and supervised the overall operation of the securities markets by setting policies, interpreting securities laws, and

[24] MOFE is now known as the Ministry of Strategy and Finance (MOSF).

authorizing the revocation of licenses for financial institutions. This led to an excessive concentration of regulatory power, ineffective supervision of financial institutions, and the failure of the system during the Asian financial crisis. Korea's financial supervisory system was completely overhauled in April 1998, under the Act on the establishment of Financial Supervisory Organizations. In 2008, the new Korean Government made a significant change in the financial supervision system by merging the Financial Policy Bureau of the MOFE and the Financial Supervisory Commission into a new financial authority, the Financial Services Commission (FSC).

35. Under the new system, the FSC supported by its executive arm, the Financial Supervisory Services (FSS), is in charge of establishing policies and supervising almost all financial intermediaries, including banks and non-bank financial institutions. The new FSC now has the power to supervise specialized banks such as the Korea Development Bank. It also carries out the function of anti-money laundering. The BOK is in charge of monetary policy management, while the Korea Deposit Insurance Corporation is given limited on-site examination authority except for financial institutions that are near insolvency. The MOSF is no longer responsible for establishing financial policies and financial regulations but retains power to: set medium and long-term economic policies; implement tax and taxation related policies; manage the national treasury and resources; and establish the foreign debt management system.

Credit Rating

36. In Korea, there are four major domestic credit rating agencies: Korea Information Service (KIS), Korea Ratings (KR), Seoul Credit Rating & Information Inc. (SCI), and the Nation Information Credit Evaluation Inc (NICE). The Korea Rating, an affiliate of Fitch, is the largest rating with a market share of 36 percent followed by KIS (a Moody's company) and NICE. Overall, the credit rating business has grown steadily and has provided a supporting environment for the development of the corporate bond market and ABS market.

Clearing and Settlement System

37. Korea has a well-developed clearing, settlement and depository system comparable to major OECD countries. The Korea Securities Depository (KSD) is the central securities depository of Korea. An amendment to the Securities and Exchange Act in 1993 established the legal basis for the KSD's depository business. The amended law defined the KSD as a special public organization designed to enhance credibility and public perception as the only central securities depository in Korea. In addition, the amendment granted KSD the legal basis to perform cross-border custody, clearing and settlement for securities. KSD is now in charge of a wide range of securities-related businesses including securities issuance, deposit and settlement. Since the major role of the KSD is critical to the Korean securities market, the KSD is subject to the supervision of the FSC. OTC settlements in bonds take place through the BOK's wire system.

Taxation

38. Under the Korean Income Tax Law, taxation of non-residents depends on whether they have a permanent establishment, such as an office or a factory in Korea. A nonresident who has

a permanent establishment faces tax liabilities that are identical to those faced by a resident. A Korean resident pays 9–36 percent individual income tax for aggregate income. Residents do not pay capital gains tax on securities transactions. In contrast, the base tax rates for foreigners are 27.5 percent for interest income as well as capital gains. For capital gains, 11 percent of total sales proceeds may apply if the amount is lower than 27.5 percent of capital gains. Tax rates are often reduced or completely exempted under applicable double taxation treaties, or agreements between the Republic of Korea and the investors' countries. As a result, most foreign investors do not pay capital gains tax. Currently, 55 countries have double taxation treaties with the Republic of Korea. However, there is currently a 14 percent withholding tax on the interest from bonds.

Thailand

Introduction

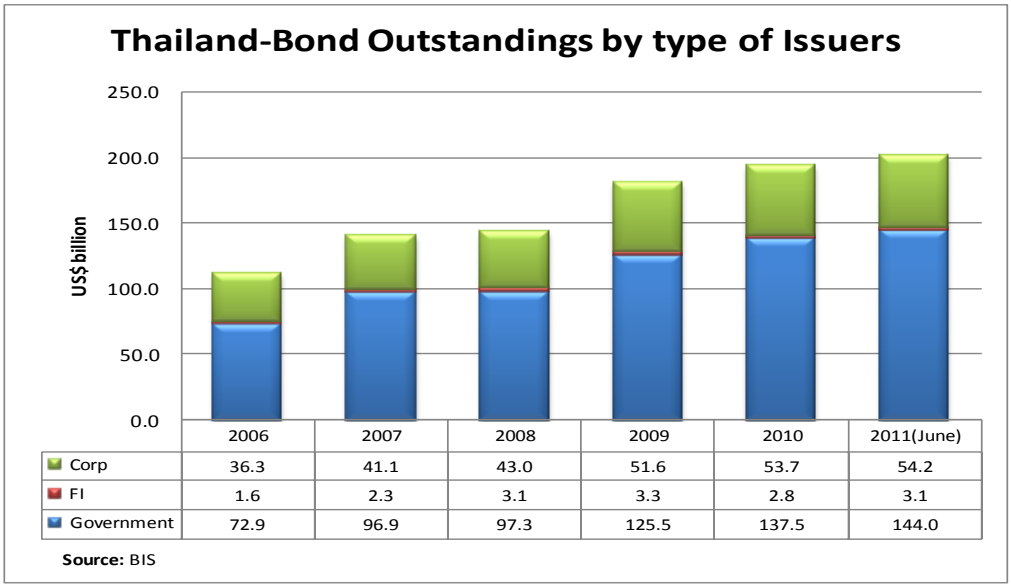
39. Thailand was the epicenter of the Asian financial crisis in 1997 when the Thai Baht devalued sharply against US$. The devaluation of the Thai Baht led to massive bankruptcy of the banking system and corporate sector. The main cause of the crisis was the total mismatch of the currency and maturity of debt of both the banking and corporate sector. Prior to 1997, the Thai financial system was totally dominated by the banking system. Since Thai companies did not have alternative sources of funding outside the banking system, they suffered severe liquidity problems that in turn led to large non-performing loans and failures of a large number of financial institutions. There was no functioning government bond market as Thailand experienced nine consecutive years of fiscal surplus between 1988 and 1996. The absence of a well functioning government bond market and sovereign interest rate benchmarks limit market participants to price corporate bonds and other financial instruments. An intervention by the International Monetary Fund (IMF) and other multilateral banks was required to stabilize the Thai financial system. Since 1997, Thailand's bond market has developed rapidly, and it now has a very well functioning government bond market and a growing corporate bond market. The Thai bond market has developed rapidly due to the concerted efforts made by the Government and key market participants in addressing key impediments facing the bond market. Regional efforts through the Asian Bond Market Initiatives and ASEAN+3 have also contributed to market development.

The Bond Market

40. At the end of 2009, the size of the Thai bond market was US$194 billion, consisting of government bonds (71.5 percent) and corporate bonds (28.5 percent). The bond market has almost doubled from US$110.8 billion at the end of 2005 (Figure D. 1). An interesting feature of the Thai bond market is that the issuance by financial institutions in the domestic market is negligible, accounting for only 1.5 percent of total bond market. The Thai banking system has performed very well. The Thai corporate sector has largely refinanced most of its foreign exchange liabilities in the domestic bond market over the last decade and funds itself largely through domestic bond market.

41. The government bond market is the largest part of the bond market, as the Government had to step in to issue a large amount of government bonds to recapitalize banks and build a liquid sovereign yield curve in support of market-risk pricing. The Thai government bond yield curve covers maturity up to 30 years although the benchmark issues are government bonds with maturity of one, two, five, seven and ten years. The five-year benchmark bond is the most liquid. A broad range of financial instruments is now available in the debt market. A variety of issuers has entered the market, including multinationals, multilateral banks and international organizations and local companies.

Figure D. 1: Thailand: Bonds Outstanding by type of Issuers



	2006	2007	2008	2009	2010	2011(June)
Corp	36.3	41.1	43.0	51.6	53.7	54.2
FI	1.6	2.3	3.1	3.3	2.8	3.1
Government	72.9	96.9	97.3	125.5	137.5	144.0

Source: BIS

42. All government debt securities and most corporate bonds are registered with the Thai Bond Market Authority (BMA). However, the trading of bonds is mostly conducted through telephone or on an over- the-counter basis. Dealers (financial institutions holding a debt securities license granted by the Securities and Exchange Commission (SEC)) are required to report all bond transactions to the Thai BMA. Thai BMA monitors, compiles and disseminates prices to the public at the end of day. Prices disseminated by Thai BMA are used as market reference. Most bonds trade on yield quoted with up to six decimal points. Market convention for price/yield formula is actual/365 basis. An attempt was made to move bond trading through an electronic platform through the Thai Bond Exchange. Government bonds are the most actively traded securities, accounting for approximately 80-90 percent of total trade.

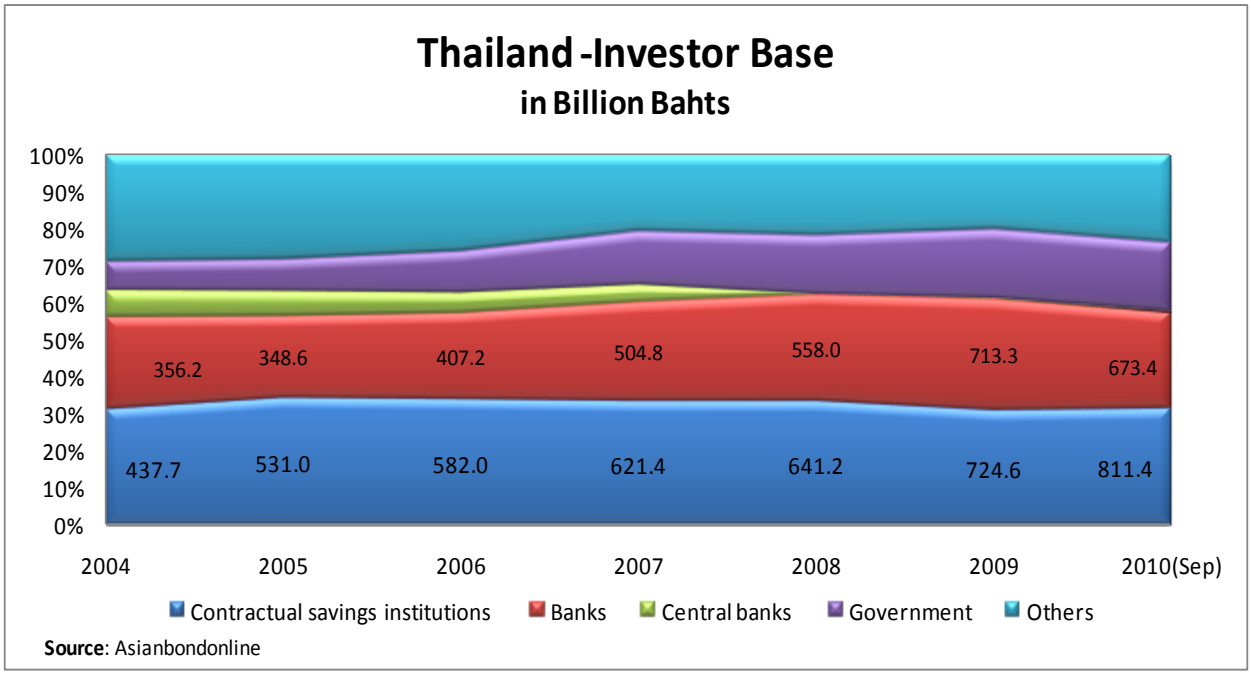
43. To enhance the efficiency of the secondary market, the BOT has set up several sub-working groups to address impediments facing secondary market trading. Measures undertaken so far include improvement in the primary dealer system, introduction of private repo market, securities borrowing and lending facility, and OTC interest rate swap market.

The Investor Base

44. Thailand now has a large investor base consisting of the contractual savings institutions, financial institutions, mutual funds and international investors. Government-owned companies are also investors in government securities. The size of the investor base at the end of 2009 was Baht 2.3 trillion (US$77 billion), compared to Bath 1.4 trillion in 2004 (Figure D. 2). The largest segment of the investor base is the contractual savings institution sector (government employee pension fund and the social securities fund), which accounted for 31 percent of the investor base. Financial institutions, insurance companies, mutual funds, provident funds, and insurance companies are also important investors. The Thai government bond market has attracted foreign portfolio investors seeking higher yield and currency appreciation. The share of foreign investors in the Thai bond market has recently increased sharply and reached Baht 157 billion, or six percent of total holding of government securities at the end of September 2010. As a result,

the Government reintroduced the 15 percent withholding tax on interest income on government securities for foreign investors.

Figure D. 2: Thailand-Investor Base



Market Infrastructures

45. Thailand has developed efficient market infrastructures for securities trading, clearance and settlement. Since 2006, the Thailand Securities Depository (TSD) is responsible for operating an integrated clearing and settlement system for government securities, corporate bonds and stocks. The integrated clearing and settlement system has enabled the TSD to provide both collateral management and bond lending services, and reduce transaction costs to investors. The TSD is also the focal point for regional clearing and settlement system linkages that are growing rapidly with the integration of ASEA financial markets. Settlement at the TSD is T+2 through a net clearing and book-entry basis. The process is governed by the Delivery versus Payment (DVP) mechanism to guarantee principal risk protection.

Regulatory Framework

46. Thailand has a well-developed regulatory framework for its securities market. The BOT is the agent of the Government for issuing government securities and supervises the operation of banking and finance businesses. These include the primary dealers that are major banks. The SEC is responsible for supervising the primary and secondary market for securities business. The issuance and offering of securities are governed by the Securities and Exchange Act 1992 (B.E. 2535). The TBDA is the self-regulatory body for bond dealers. It has implemented a number of standards and conventions for bond trading. The Stock Exchange of Thailand is the SRO for members of the exchange.

Rating Agencies

47. The three major rating agencies (Moody's, Standard and Poor's and Fitch) and TRIS, a local rating agency, operate in Thailand. Credit rating is mandatory for companies seeking approval for debt securities issuance from the Securities and Exchange Commission of Thailand. TRIS was promoted by the Government, and its shares are owned by major banks and the Asian Development Bank.

Taxation

48. The Thai taxation is friendlier to equity market investors than fixed income investors. Capital gains on investments in the stock market are tax-free, and there is no tax on dividend income for non-resident investors due to the existence of double taxation treaties with several countries. Fixed income investors are subject to tax on interest income, discount and capital gains. Both resident and non-resident investors are subject to 15 percent withholding tax on interest income and capital gains. The tax rate may be reduced to 10 percent for investors from countries that have double taxation treaties with Thailand. Capital gains tax for zero coupon debt instruments is exempt for individual investors, while there is a 15 percent tax on interest income from coupon bonds. Capital gains from bond trading are exempt from Thai tax for nonresidents. In 2008, Thailand waived the 15 percent withholding tax on interest income from bonds for foreign investors to attract foreign investment in domestic bond markets. However, this exemption was withdrawn in October 2010 due to large inflows of foreign portfolio investment in the fixed income market. The decision was driven largely by the concern about financial stability.

Derivatives

49. The over-the-counter market in financial derivatives (foreign exchange and interest swaps) is relatively well developed. Currency swaps of up to five years are available. The size of derivatives traded on the newly established future exchange is very small and is still evolving. The growth of the derivatives market in Thailand has been uneven, due to an unpredictable government policy regarding foreign portfolio investment in the domestic bond market.

South Africa

Introduction

50. The South African local debt market is the most developed in Africa and one of the most vibrant fixed income markets among emerging economies. In 2009, the total size of the local currency bond market was US$140.4 billion, or 48.9 percent of GDP. There has been a significant growth in its corporate debt segment over the last decade. The corporate bond market has more than tripled between 2000 and 2009 in nominal terms, increased by five percent in GDP terms. This growth is largely related to macroeconomic stabilization, which resulted in lower borrowing requirements for the Government and lower yields in the market, giving more room to corporations to issue debt at increasingly favorable terms. Additionally, South Africa has been successful in developing a relatively sophisticated investors' base, including several specialized fixed income funds. This helped create the appetite for more diversified offerings in the bond market, making it easier for corporations to issue debt.

51. As of December 31, 2009, the outstanding amount of corporate debt (financial institutions and non-financial corporations) amounted to US$53.8 billion or 38 percent of the total outstanding debt in local currency. However, similar to many emerging markets, banks remain the biggest issuers in the corporate segment. A proposed regulation would raise limits for pension funds' investment in banks, and this will likely encourage the dominance of banks.

Local Debt Market: Issuers and depth of the market

52. The outstanding amount of corporate debt by the type of issuers is shown in Figure E. 1 and Figure E. 2. The share of non-government issuers has been increasing over time, with corporate issuance suffering a setback following the global financial crisis. The share of parastatals (state-owned entities) is likely to increase over time, given the aggressive investment plans and proposed regulations that will increase the pension funds' limits for investments in these entities.

Figure E. 1: Outstanding Debt by Issuer (US$ B)

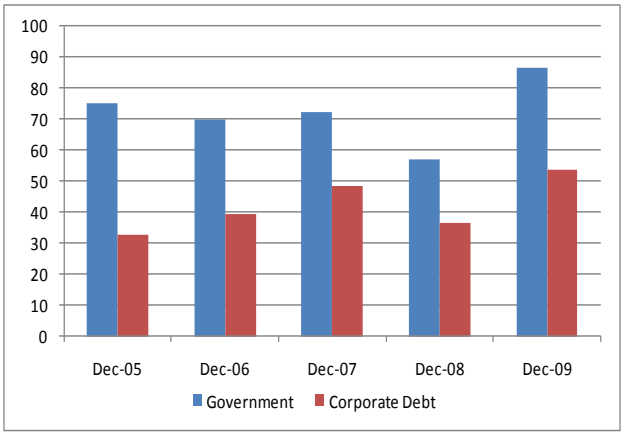


Figure E. 2: Outstanding Debt by Issuer (R B)

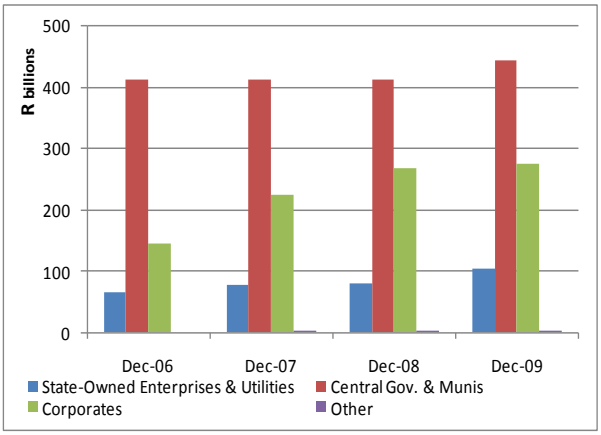
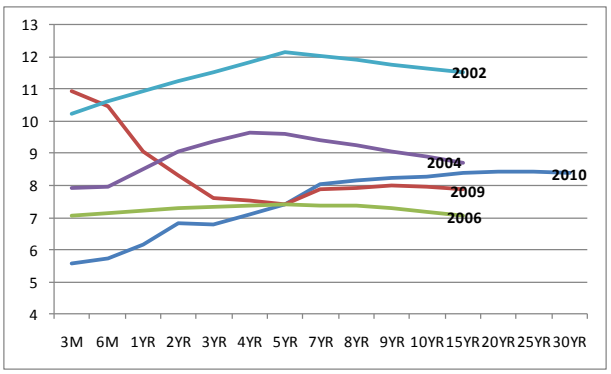
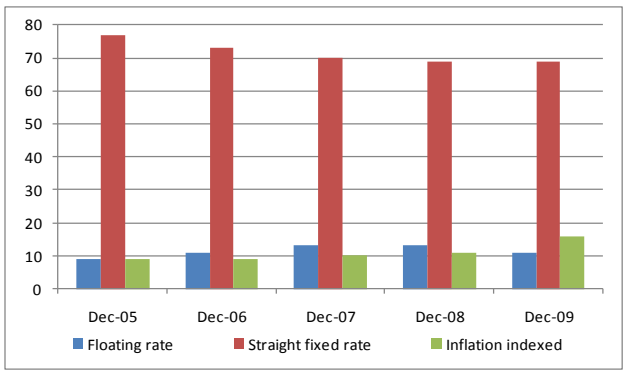


Figure E. 3: Evolution of Yield Curve

Figure E. 4: Type of Instruments (% of Total)



Source: Bloomberg



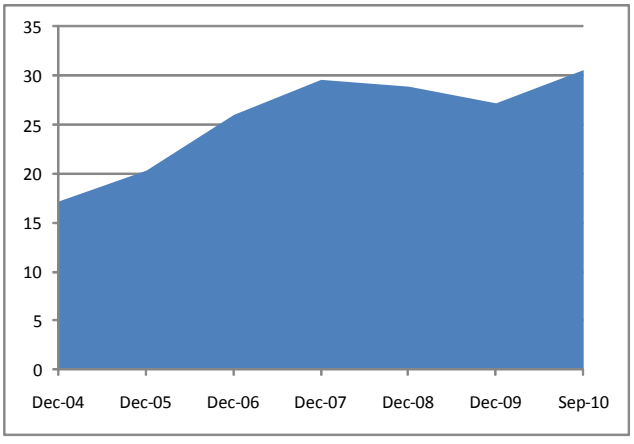
Source: BIS

53. The South African government bond market has a high average maturity (Figure E. 3), with a sovereign curve extending to 26 years, and a high participation of fixed-rate bonds in its composition (72 percent). The annual listed bond turnover is 15 percent and liquidity is concentrated in two issues (R157 matures in 2014/15/16 and R187 matures in 2025/26/27). Given the small size of issuances, the liquidity is limited in the corporate bond market segment.

Investors' Base

54. Major local investors in South Africa include the Public Investment Corporation (PIC — which manages the government employees' pension fund), banks, other pension funds, insurance companies, collective investment schemes and foreign investors.

Figure E. 5: Collective Investment Schemes – AUM (% of GDP)



Source: JSE, as of Q3 2010

55. The total assets of official pension and provident funds at the second quarter of 2009 were US$96.6 billion (33.6 percent of GDP), while in the same period the total assets of private self-administered pensions and provident funds amounted to US$61.6 billion (21.5 percent of GDP). Total assets of long-term insurers were US$159 billion (55 percent of GDP) at the second quarter of 2009.[25] Assets under management of collective investment schemes reached US$79 billion, or 27 percent of GDP at end-2009. There are no restrictions on the participation of foreign investors in the market. Although in overall terms foreigners hold a small share in the market, they are very active participants (non-residents transactions accounted for 44 percent of total fixed income market turnover in September 2010), but their holdings tend to be volatile.

[25] African Development Bank Group, "African Fixed Income and Derivatives Guidebook," 2010.

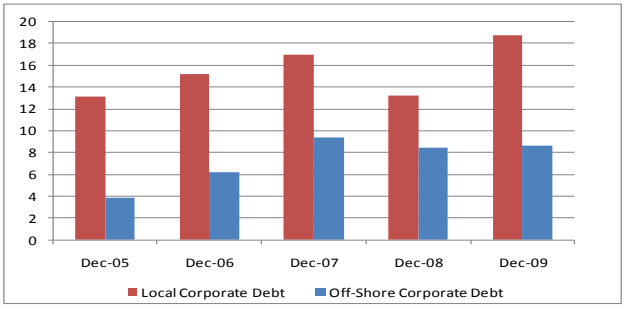
Box E. 1: Proposed legislative changes to regulation imposing limits to the pension funds' investments

There are legislative changes under way in order to revise some of the provisions of the "Regulation 28," which prescribes the maximums for the various types of investments that can be made by a retirement fund. Thus far, investments in corporate bonds — with pension savings — were restricted to 25 percent of the portfolio. The new legislation proposes this percentage be increased to 75 percent for investments in debt issued by banks, because banks are prudentially regulated. The final version of this legislation will be drafted early next year. The new 75 percent limit will also be applied towards quasi-government agencies like state-owned entities, in order to raise capital for these entities and relieve state pressure for all their funding requirements. For other corporations, the limit of 25 percent will be retained. In addition, the new regulation proposes a limit of 30 percent across all unlisted assets. Investments into unlisted debt are proposed to contribute towards this 30 percent limit.[26]

Corporate Bond Market

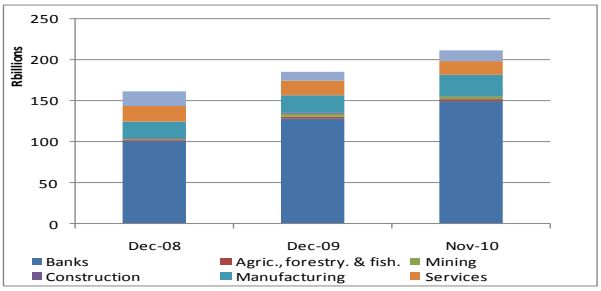
56. The growth in the corporate bond market has been significant on the back of declining interest rates in the years before the global financial crisis (mid-2003 to mid-2006) and lower supply of the government paper, which gave more "space" to corporations to tap the bond market. Parastatals and corporate issuers have been active in primary markets for both short-term and long-term debt. Following the setback in 2008, the total outstanding corporate debt exceeded 18 percent of GDP in 2009. Banks have been at the forefront of the growth in the corporate bond market and still account for the bulk of the corporate issuance (Figure E. 7). Despite these developments, most corporations still raise funds through banks loans and equity issuance. Leveraging abroad has been more popular lately, as South African corporations gained more access to international markets.

Figure E. 6: Corporate Debt (% of GDP)



Source: BIS

Figure E. 7: Structure of Local Corporate Debt by Issuer



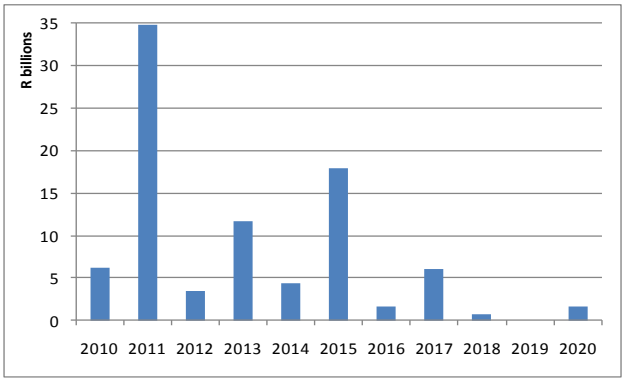
Source: JSE

57. Securitizations listings also increased substantially in the years before the financial crisis, on top of the boom in the South African property market and overall credit expansion. Interest rates started to climb during the second half of 2006, peaking in mid-2008, and declining afterwards. Demand for credit has struggled to recover and is only just starting to show signs of revival. As a result, the nominal value of securitizations has consistently declined over the past

26 JSE and the SA Treasury website.

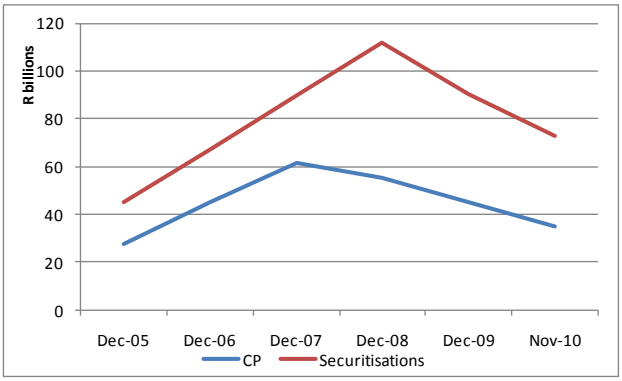
two years[27] (Figure E. 9). Corporate paper issuance has become more popular over the years. However, its share in total corporate debt has been decreasing since December 2009, suggesting investors regaining appetite for longer-term debt.

Figure E. 8: Term Structure of Local Corporate Debt



Source: JSE, 2010 issuances, X axis - maturities

Figure E. 9: Evolution of Securitizations and CP



Source: JSE

58. In the corporate debt issued in 2010, one-year maturities are the most frequent, followed by five-year maturities. In terms of pricing, the bulk of corporate debt is issued at floating coupon rates, with a fixed spread above three-month JIBAR, and in the majority of cases with four annual coupon payments.

Regulatory Framework

59. The Financial Services Board (FSB) is responsible for regulating and supervising financial markets. The role of self-regulating agencies is also significant. South Africa's well-developed commercial law legislation is progressive and aligned with international standards in financial disclosure and corporate governance. The Securities Services Act of 2004 applies to securities listed for trading on exchanges. In the "Assessment of IOSCO principles,"[28] the World Bank and the IMF recommended more reporting and oversight for the OTC trading.

Credit Rating

60. Major international credit rating agencies are present in South Africa, including Moody's, Fitch and S&P. There are also smaller regional and local players, whose ratings are accepted for domestic issuances. The credit rating is required for corporations to issue bonds in the local market.

[27] The corporate bond market features presented here are based on the comments and email exchanges with a JSE's senior strategist.
[28] October, 2010.

Market Infrastructure: Trading, Clearing & Settlement

61. Given the small size of issuances, corporate bonds do not trade much, and most of the investors have a buy and hold approach. Limited trading activity usually takes place OTC, although trading can be done on the JSE too. There are also BEASSA total return indices including the all bond index (ALBI), the Government bond index (GOVI) and the other bond index (OTHI). The ALBI is made up of the top 20 listed bonds, ranked by market capitalization and liquidity. The GOVI comprises those RSA bonds in which primary dealers are obliged to make the market. The OTHI comprises the remainder of the bonds in the ALBI. There are also Standard Bank Credit Indexes that are mostly comprised of debt issued by private entities. Strate is authorized Central Securities Depository for the electronic settlements of all the financial instruments in South Africa. OTC trades are reported by the trade participants into the Strate system.

Derivatives

62. The market for fixed income derivatives is relatively well developed in South Africa, with liquid currency swap markets. The interest rate cross-currency swaps extend to 30 years, but they are liquid up to five years. The liquid maturities for single currency swaps are two, five and 10 years. There is also an active market of forward rate agreements and a range of interest rate derivatives offered by the JSE[29].

Taxation

63. There is no withholding tax on bonds, but interest earned on bonds is taxable as interest income to an investor.[30]

[29] JPMorgan, "Local Markets Guide", November 2009.
[30] African Development Bank Group, "African Fixed Income and Derivatives Guidebook 2010.

Annex 4 Derivatives-Primer

Derivatives-Primer

A **derivative** is a transaction that is designed to create price exposure, and thereby transfer risk, by having its value determined – or derived – from the value of an underlying commodity, security, index, rate or event. Unlike stocks, bonds and bank loans, derivatives generally do not involve the transfer of a title or principle, and thus can be thought of as creating pure price exposure, by linking their value to a *notional* amount or principle of the underlying item. Examples of derivatives include forward contracts, options, and swaps.

Forward contract is the simplest and perhaps oldest form of a derivative. It is the obligation to buy or borrow (sell or lend) a specified quantity of a specified item at a specified price or rate at a specified time in the future. A forward contract on foreign currency might involve party A buying (and party B selling) 1,000,000 Euros for US$ at US$1.35 on June 30, 2010. A forward rate agreement on interest rates might involve party A borrowing (party B lending) US$1,000,000 for three months (91 days) at a two percent annual rate beginning June 1, 2010.

Foreign exchange forward is a contract in which counterparties agree to exchange specified amounts of foreign currencies at some specified exchange rate on a specified future date. The forward exchange rate is the price at which the counterparties will exchange currency on the future date. The forward rate is usually negotiated so that the present value of the forward contract at the time it is traded is zero; this is referred to by describing the contract as trading at par or "at the market." As a result, no money need be paid at the commencement of the contract because the market value of a par contract is zero; although a contract is at the market, counterparties sometimes agree to post collateral in order to insure each other's fulfillment of the terms of the contract.

Futures contracts are like forwards, but they are highly standardized, publicly traded and cleared through a clearinghouse. The futures contracts traded on organized exchanges such as the Chicago Mercantile Exchange (www.cme.com) in the United States are so standardized that they are fungible – meaning that they are substitutable one for another. The futures are therefore highly liquid, actively traded and therefore reflect market prices. Clearinghouses are used to clear exchange-traded futures contracts. Trades from the exchange floor are reported to the clearinghouse, and the contracts are written anew, or *novated*, so that the clearing house becomes the counterparty to every contract. In this manner, the clearing house assumes the credit risk of every contract traded on the exchange. The front line defense against contract default is the margin accounts, ranging from 3 to 5 percent of the contract. Futures are marked to market daily, and the exchange also reserves the right to make intra-day margin calls to protect the integrity of the futures (and options) market in the event of an exceptionally large price swing. If a trader fails to meet margin requirements, the exchange reserves the authority to liquidate the trader's positions.

Options. An option contract gives the buyer or holder of the option (known as the long options position) the right to buy (sell) the underlying item (stock, bonds, foreign exchange, gold, etc.) at a specific price, at a specific time period, in the future.

A **call option.** On a stock, the holder has the right to buy the underlying stock at a specified price – known as the strike or exercise price – at a specified time in the future. If the spot market price of the stock were to exceed the strike price during the time period in which the option could be exercised, then the holder would be able to exercise the option and buy at the lower strike price. The value of exercising the option would be the difference between the higher market price and the lower strike price. If the market price were to remain below the strike price during the period when the call option was exercisable, then the option would not be worth exercising and it would expire worthless.

A **put option**. The option holder has the right to sell the underlying item at a specified price at a specified time in the future. Imagine a situation in which a farmer has purchased a put option on the price of corn. If the spot price of corn were to fall below the strike price during the period in which the option was exercisable, then the farmer would be able to exercise the option and sell at the higher strike price. In this way, the put option acts as a form of price insurance that guarantees a floor or minimum price. Like an insurance policy, the price paid for the option is called a *premium*. The value of exercising this put option would be the difference between the higher strike price and the lower market price. American-style options can be exercised over a specified period that is usually the life of the contract, while European style options can be exercised only on the expiration date.

Swaps. Swap contracts, in comparison to forwards, futures and options, are one of the more recent innovations in derivatives contract design. The first currency swap contract, between the World Bank and IBM, dates to August of 1981.

Foreign exchange swap. A foreign exchange swap is simply the combination of a spot and forward transaction (or possibly two forwards). The start leg of the swap usually consists of a spot foreign exchange transaction at the current spot exchange rate, and the close leg consists of a second foreign exchange transaction at the contracted forward rate.

Foreign exchange forwards and swaps are used by both foreign and domestic investors to hedge foreign exchange risk. Foreign investors from advanced capital markets purchase securities denominated in local currencies and use foreign exchange forwards and swaps to hedge their long local currency exposure. Similarly, foreign direct investments in physical real estate, plant or equipment are exposed to the risk of local currency depreciation. Local developing country investors who borrowed in major currencies in order to invest in local currency assets are also exposed to foreign exchange risk, and they too use foreign exchange forwards and swaps – as well as futures and options where available – to manage their risks.

***Source**: Financial Policy Forum.*

Annex 5 Legal, Regulatory and Tax Frameworks Relating to the Bond Market

Introduction

1. **Turkey has a relatively well-developed financial market regulatory system; however, the interaction between the various players as it pertains to market development is complex.** The Banking Regulation and Supervision Agency is responsible for bank supervision. The Capital Markets Board of Turkey is in charge of regulating and promoting prudent development of the capital markets. The Under-Secretariat of Treasury supervises the pension and insurance industry though its main function is to finance the budget deficit and manage the debt portfolio. The Central Bank of the Republic of Turkey works closely with these organizations to foster development of the financial markets and reduce systemic risks. The CBRT has overall responsibility for monetary policy and systemic risks. Elements of corporate bond market development touch various aspects of these agencies, and it is imperative to have a collective approach towards fostering prudent development of the market and working together to remove the impediments.

Securities Market Regulations in Turkey

2. **The main law governing capital markets in Turkey is the Capital Market Law (CML) No. 2499, which became effective on July 30, 1981**. The CML is a comprehensive law that sets out a broad framework for regulating capital market activities; capital market intermediaries; self-regulatory organizations; and other capital market related organizations. Banks that carry out capital market activities are regulated by the BSRA even though there is close coordination between the BRSA and CMB.

The Capital Markets Board of Turkey

3. **Article 22 of the CML gives the sole regulatory and supervisory authority of capital markets to the CMB**. The CMB aims to ensure the safe, fair and orderly functioning of the capital markets while protecting the rights and interests of investors. Its ultimate objective is to foster the development of the securities markets and contribute to the efficient allocation of financial resources within the Turkish economy. A unique feature is that the CMB is statutorily charged with a dual mandate: it is responsible for regulating and supervising the securities markets as well as to develop them.

4. **The CMB was established in 1981 as an independent statutory public organization with financial autonomy**. The CMB is governed by the Executive Board, which is the main decision-making body. The CMB regulates and supervises public companies, listed companies, financial intermediaries, exchanges, mutual, closed-end and pension funds, the Settlement and Custody Bank (Takasbank), the Association of Capital Market Intermediary Institutions of Turkey (TSPAKB), the Central Registry Agency, and other related institutions operating in the capital markets, such as the independent audit firms, rating agencies, etc.

5. **Capital Markets activities are defined under Article 30 of the CML.** All such capital markets activities are subject to regulation by the CMB. These activities include: (i) the public

offering or issuance of capital markets instruments that are to be registered with the CMB; (ii) secondary market trading of capital markets instruments; (iii) offering and trading of derivative instruments including futures and options contracts based on economic and financial indicators, capital markets instruments, commodities, precious metals and foreign currency; (iv) the buying and selling of the capital markets instruments with the agreement to repurchase or resell them; (v) investment advisory services; (vi) portfolio management and administration; and (vii) activities of other capital markets institutions such as mutual funds, venture capitals and other collective investment schemes. Banks in Turkey can not perform most of the capital market activities listed above, and they do it through setting up a special subsidiary and acting as an agent.

Issuance of Debentures and Other Debt Instruments

6. **Rules and regulations concerning issuance of debentures and other debt instruments are defined in Article 13 of the CML**. The Law authorizes CMB to regulate the issuance and sale of debt securities via communiqués. The current communiqué on *Principles Regarding Registration and the Sale of Debt Securities (Serial: II, No: 22)* was issued in 2009. The communiqué lays down comprehensive requirements that are similar to those under a standard prospectus. The limits for debt issuance by municipalities and state enterprises are prescribed by the Council of Ministers. The issue limits established by legislation shall not apply to issues that are accompanied by guarantee of the Government of Turkey. Publicly-held joint stock companies can issue debt up to five times of their net worth, as in the latest audited report if it is a public offer and 10 times if it is a private placement.

7. **Mortgage Covered Bonds are debt securities that provide full recourse to the issuer, and they are secured by assets in the cover pools**. The issuance of mortgage covered bonds in Turkey is governed by Article 13/A of the Law. Mortgage covered bonds can be issued by banks and mortgage finance corporations. Issuers are required to register the collateral assets in a cover pool, separate from their other assets in accordance with the guidelines prescribed by the CMB with the consent of the BRSA. The cover pool may consist of receivables secured by mortgages on authorized houses and other authorized real estate properties, substitute assets and hedging arrangements against the risks associated with these. No assets other than these may be included in the cover pool. The CMB also imposes certain limits to ensure financial soundness of the covered bonds. For receivables secured by mortgages on authorized houses and other authorized real estate properties to be included in the cover pool, all the payments due up to date of inclusion must have been made by the debtor. Substitute assets may consist of cash, domestic public debt instruments, securities issued under treasury guarantee, securities issued by governments or central banks of OECD member states, and other similar securities acceptable to the CMB. Receivables secured by mortgages on other authorized real estate properties and substitute assets may not be higher than 15 percent of the cover pool for each.

8. **Issuers may enter into contracts in order to protect assets in the cover pool from interest rate, currency, credit and similar risks**. These contracts are also part of the cover pool. The issuers must ensure that: (i) the nominal value of the assets in the cover pool must equal or exceed the nominal value of the mortgage covered bonds; (ii) the yield from the assets in the cover pool must equal or exceed the yield of the mortgage covered bonds; (iii) revenues from the assets in the cover pool must meet the payments to the mortgage-covered bond holders in terms of

amount and payment time; and (iv) the net present value of the assets in the cover pool must exceed the net present value of the mortgage-covered bonds by two percent.

Self-Regulatory Organizations

9. **Istanbul Stock Exchange: Set up in 1983, the activities, operating principles and supervision of securities exchanges were defined by the Council of Ministers through the Decree Law on Securities Exchanges** (Decree law No. 91). The Decree provides a framework for the transparent, sound and prudent operation of securities exchanges in Turkey. It came into effect in 1985 and was revised in 1996. The Regulation Concerning the Establishment and Operation Principles of Securities Exchanges details the functioning of securities exchanges. The Regulation sets forth the principles and rules of operation for the Istanbul Stock Exchange. The ISE was established in December 1985 and started its operations in January 1986.

10. **The Istanbul Stock Exchange was established as a public institution, with the authority to provide an organized trading platform and to inform the public by disseminating securities prices.** The Chairman is appointed by the Government, but the remaining four Board Members are elected by the General Assembly from among its members. ISE has some self-regulatory authority over its members and has its own budget, but major decisions are subject to CMB approval. Currently the main markets are the equities market and bonds and bills market operating in the ISE. The public institution structure forces the ISE to comply with a number of operating restrictions that limit its efficiency (e.g. procurement laws). There are plans for defacto de-mutalization of the ISE to clarify the ownership structure.

11. **There are two basic requirements to list debt instruments at the ISE**. Firstly, the nominal value of the issue must be at least TL1,100,000 and, secondly, the entire amount of the issue must be offered to the public. Also, there are other conditions and documents required from the issuer:

- At least three calendar years must have passed since the establishment of the company;
- The latest financial statements must be independently audited;
- The company must have a profit-before-tax for the last two years. If the company is already listed with a free-float of at least 25 percent, only the previous year's profitability is required;
- The shareholders' equity of the company must be at least TL1.76 million;
- The company's Articles of Incorporation must not include any provisions restricting the transfer and circulation of the securities traded on the Exchange or preventing the shareholders from exercising their rights;
- Unlisted corporate bonds, which have been registered with the CMB, can be traded on the ISE Bonds and Bills Market, with the approval of the Executive Council. These securities must be sold entirely through public offering.

12. **Turkish Derivatives Exchange Inc.** (TurkDex). TurkDex was set up in July 2002 as a private company in Izmir and became operational in February 2005. It is the only derivatives exchange in Turkey. TurkDex has 11 shareholders, with the major shareholders being the Union of Chambers and Commodity Exchanges of Turkey and the Istanbul Stock Exchange. As of March 2010, TurkDex offers contracts in currency futures, interest rate futures, equity index

futures and commodity futures. Option contracts are under consideration. TurkDex operates on an electronic trading platform.

13. **The Istanbul Gold Exchange (IGE) became operational in July 1995.** The IGE has two main markets: (i) precious metals market (spot transactions for gold, non-standard gold, silver and platinum); and (ii) precious metals lending market (for gold). Silver and platinum trading started in December 1998. Non-standard gold transactions within the Precious Metals Market were launched in October 1999. This enables scrap gold trading in a secure environment by eliminating counterparty risk. It also removes assaying concerns regarding non-standard bullions. The Precious Metals Lending Market started operations in March 2000.

14. **The Association of Capital Market Intermediary Institutions of Turkey (TSPKAB) is a self-regulatory organization for non-bank financial intermediaries and subsidiaries of the banks that are involved in capital market activities.** TSPKAB sets rules and professional standards for its members to ensure compliance with the CML and other regulations. TSPKAB is empowered to take disciplinary actions against its members who fail to meet the compliance requirements or are in violation of professional standards.

15. **The Banks Association of Turkey (BAT) is a self-regulatory organization for all banks, excluding Islamic banks.** All deposit banks, development and investment banks (including Takasbank) operating in Turkey are members of the BAT. BAT determines professional principles and sets standards for members. The Participation Banks' Association of Turkey (PBAT) is the self-regulatory organization for participating banks that operate under interest free (Islamic) banking principles. PBAT has the same power as BAT on its members.

Other Securities Markets Organizations

The ISE Settlement and Custody Bank Inc.

16. **ISE Settlement and Custody Bank Inc (Takasbank) is the clearing and settlement center for the Istanbul Stock Exchange and the Clearing House for the Turkish Derivatives Exchange.** Apart from these functions, Takasbank operates the money market and the securities lending and borrowing market, provides banking services including cash loans to members, and other services such as cross-border settlement and custody. Takasbank was established in 1988 as a department of the ISE. In January 1992, Takasbank was established to take over the operations of the department in ISE. Hence, Takasbank was set up under the Turkish Banking Law and incorporated as a non-deposit taking bank. Since Takasbank is registered as a bank, it is supervised by BSRA as well as the CMB. Settlement of transactions is done through Delivery Versus Payment, with daily netting. The total number of institutions benefiting from the services provided by Takasbank is 810.

17. **The Central Registry Agency Inc. (CRA) is the only central depository for all dematerialized capital markets instruments.** It was established in 2001 as a private company. The communiqué about the terms and conditions for the registration of dematerialized capital markets instruments was enacted in December 2002. The dematerialization process was completed in 2006 for equities, and in 2007 for mutual funds and corporate bonds. With the CMB Decision on October 15, 2004, starting from May 2005 the dematerialization process of mutual

funds has been initiated with selective institutions. All mutual fund participation certificates and liquid funds participation certificates had been dematerialized by March 2006.

Investors' Protection Fund

18. **To protect the investing public, the CML (Article 46/A) stipulates the creation of an Investors' Protection Fund, with a separate legal entity to cover the cash payment and share delivery obligations arising from share transactions for the customers of capital markets intermediaries.** All capital markets intermediary institutions are required to participate in this Fund. In 2001, ISE contributed the initial capital of TL10 million into the Investors` Protection Fund. The Fund is resourced from the annual levies to be paid by the intermediary institutions and half of the administrative penalty fines imposed by the CMB on capital markets intermediaries, the ISE and TSPAKB. The Fund's assets are invested in government bonds, T-Bills, deposits or reverse repos. The total value of the Fund's assets reached TL178 million by the end of 2009. The claim payments arising from settlements or arbitration are made by the Fund within a limit stipulated by the CML and it is adjusted on an annual basis. The maximum amount for each customer to be paid from the Fund's assets was TL57,874 in 2009 and for 2010, the Fund covered up to TL59,147 of receivables per investor.

19. **Other relevant laws and regulations that have significant impact on the capital markets are the Decree on the Value of the Turkish Currency (Decree No. 32) and the tax law**. Decree No. 32, regarding the "Protection of the Value of the Turkish Currency," was enacted in August 1989 to allow non-residents to invest in Turkish securities and vice versa, through financial intermediaries authorized by the CMB. An amendment to this Decree in February 2008 defines the foreign currency transactions of brokerage firms. Accordingly, brokerage firms can buy and sell foreign currency as long as it is done with their clients and for the purpose of trading securities, which previously was not possible.

Key Milestones of Turkish capital markets:

1981	Capital Markets Law passed.
1982	Capital Markets Board established.
1985	Istanbul Stock Exchange established.
1987	First mutual fund issued.
1989	Settlement and Custody Dept. established within ISE; Liberalization of foreign investments.
1991	Bonds & Bills Market established within ISE.
1992	Settlement and Custody Inc. established as a company; Corporate bond market established within ISE.
1993	Repo-Reverse Repo Market established within ISE; Automated trading started with 50 companies.
1994	Settlement on T+2. Fully automated trading started.
1995	Settlement and Custody Bank (Takasbank) was formed; Istanbul Gold Exchange established; new Companies Market established within ISE; International Securities Market established within ISE.
1996	Securities Lending & Borrowing Market established within Takasbank.
1997	Banks are permitted to establish brokerage subsidiaries. First asset Management Company established.

1998	First credit rating agency established.
1999	Client-based custody at Takasbank.
2000	Market making system introduced for government bonds. First venture capital trust offered to public.
2001	TSPAKB (Association) established; Investors' Protection Fund established; futures market established within ISE; Central Registry Agency established and remote trading started at ISE.
2002	Pension system regulation passed.
2003	Corporate governance principles published; first private pension fund established; International Financial Reporting Standards adopted.
2004	First Exchange Traded Fund established.
2005	Turkish Derivatives Exchange established; dematerialization of equities completed
2006	Dematerialization of corporate bonds and mutual funds completed; Twinning project between CMB and Germany's BaFin to comply with EU standards.
2007	Opening auction introduced at ISE for the first session; Mortgage Law passed; Eurobond market established within ISE.
2008	New IFRS regulation adopted; IPO Awareness Campaign initiated.
2009	Automated Disclosure Platform introduced; ISE Emerging Companies Market established; Collective Products Market established within ISE and Istanbul International Financial Center strategy announced. Abolition of withholding tax for both resident and non-resident investors.
2010	Shelf registration for bonds introduced. Regulations regarding IPOs eased; first warrant issued and market making introduced for warrants, ETFs, and investment trusts.
2011	Lowering of tax from 5 percent to 1 percent for corporate bonds.

Securities Market Regulations post 2010 (Euro convergence)

20. **The existing Turkish capital market law and regulations are a combination of rule-based (merit) and principle-based (disclosures) systems for the regulation of securities offerings**. The CML is a merit-based law and has gone through several modifications to move towards a disclosure-based system similar to the one in the United States. As a part of the IFC-Istanbul project, the Government of Turkey has made it a priority to realign the financial market regulations with international best practices. Accordingly, the present prescriptive approach to regulation will be replaced by a principle-based approach in which market entry and exit are facilitated; market activities may be carried out unless otherwise prohibited; new products may be offered unless disallowed explicitly – all these changes will allow for market innovations and enhance market efficiency. A well-crafted risk management system to handle systemic risk is being contemplated.

21. **Regulatory priorities envisaged by the CMB for the near future include:**

- Demutualize the Istanbul Stock Exchange;
- Create an Alternative Market for small and medium sized enterprises similar to other countries;
- Revise CML in line with current EU requirements. In this connection, a project for the Strengthening of the Capital Markets Board has been approved by the European Commission and implementation is underway to strengthen the CMB;
- Modernize regulations for the FOREX market;

- Improve the securities lending system for the Bond market;
- Carry out studies relating to the Strategy and Action Plan for Istanbul International Finance Center;
- Introduce new regulation for corporate spin-offs of publicly held companies in harmonization with EU legislation;
- Amend regulations on credit rating agencies in line with the EU Directive on rating agencies and IOSCO principles;
- Train educators to organize courses on International Financial Reporting;
- Carry out studies on the establishment of venture capital funds; and
- Introduce effective dispute resolution mechanisms for securities transactions for organized and OTC markets.
- The CMB can also include in its priorities adoption of the new IOSCO Principles of Securities Regulations which have been updated in July 2010. The update includes inclusion of eight new principles and update of several others.

22. **The above regulatory agenda is clearly an ambitious one that aims at transitioning the Turkish financial market regulations to international standards and best practices over the next two to three years.**

Tax Framework

23. **Turkey has one of the most competitive corporate tax rates in the OECD region**. The 2006 Corporate Tax Law introduced several amendments to the current tax laws and regulations and brings them much closer to international tax regimes. However, the tax structure in Turkey is still relatively complex. Complicating the analysis is the difference in treatment of residence and non-residence, institutions, dividend, interest income from government securities and bank deposits. There is also taxation on banking transactions, known as the Banking and Insurance Transaction Tax, which is unique to Turkey as taxes are calculated as a percentage of interest. This leads to an increase in fund costs for both financial institutions and their clients, and intermediation costs will rise with an increase in the lending rate. The need for additional reforms of tax laws and regulations is well appreciated by the Government of Turkey and it is built into the strategy and action plan to transform Istanbul into an International Financial Center.[31] The discussion in this chapter focuses on taxation of capital market instruments, especially debt instruments.

24. **Turkey has a liberal foreign investment policy with respect to taxation**. There are no restrictions on foreign investments or the repatriation of capital and profits. Foreign individuals and corporations (including investment trusts and investment funds abroad) can freely purchase and sell securities and other capital market instruments. However, a foreign investor must use a Turkish intermediary for buying and selling of securities, repo transactions, portfolio management, investment consultancy, underwriting, margin trading and securities lending. Since October 2010, residents and non-residents are taxed equally.

[31] State Planning Agency, Strategy and Action Plan for Istanbul International Financial Center (IFC-Istanbul), October 2009.

Debt Instruments

Government Bonds and T-Bills:

25. **Foreign Portfolio Investment.** Since most GSD have maturity of less than 22 months, taxation on these instruments is governed by the Temporary Article 67. Under this law, the rate of tax for foreign investors is currently reduced to zero percent, and it is the final tax. In addition, a 0.1 percent financial transactions tax applies to all onshore spot transactions, with the exception of the interbank market. Capital gains on government securities are also tax exempt for foreign portfolio investors. Many emerging market countries including Brazil, Chile, Indonesia, and Thailand have recently reintroduced withholding tax on interest income on bonds to slow down appreciation of local currency and lessen the burden of currency appreciation on exporters and central bank profitability. Turkey has thus far refrained from imposing withholding tax on investment in the domestic bond market. Given that Turkey has a small domestic investor base, it may be unwise to impose taxes at this point as it could lead to more volatility. Foreign portfolio investors, especially bond market investors, are highly sensitive to taxes.

26. **Domestic Investors (Residents).** Major investors in government securities are banks and domestic institutional investors (insurance companies, pension funds, and mutual funds). Interest and capital gains earned by pension funds are tax exempt. Insurance companies and banks pay taxes based on their corporate tax rate that is currently 20 percent. Individual investors are subject to 10 percent withholding tax, and it is the final tax. The personal income tax rate in Turkey ranges from 15 to 35 percent.

Corporate Bonds:

27. **Foreign Portfolio Investors.** Foreign investors are currently subject to zero percent withholding tax on interest income from corporate bond and zero percent tax on capital gains. Thus far, foreign portfolio investors have not been meaningful investors in corporate bonds as there are no corporate bonds with high credit rating and there is practically no liquidity in the domestic corporate bond market.

28. **Domestic Investors (Residents).** Interest income and capital gains tax from corporate bonds is subject to 10 percent withholding tax and it is the final tax. Most investors in the existing corporate bonds seem to be overseas Turkish investors.

Bank Deposit:

29. **Foreign Investors.** Interest income earned from bank deposits is subject to zero percent withholding tax.

30. **Domestic Investors (Residents).** Interest income earned from bank deposits is subject to 15 percent withholding tax that is substantially higher than withholding tax on government and corporate bonds. The rationale for higher withholding tax is not very clear, and it appears to favor investment in GSD, which carries a lower withholding tax. Harmonization of withholding taxes across all debt instruments will eliminate distortion and create a level playing field.

Bank and Insurance Transaction Tax (BITT)

31. **Banking and Insurance company transactions are subject to a Banking and Insurance Transaction Tax.** This tax applies to income earned by banks, e.g. loan interest. The general rate is five percent, while interest on deposit transactions between banks is taxed at one percent and sales from foreign exchange transactions at 0.1 percent. BITT is currently exempt from VAT. In addition to BITT, there is a stamp duty that applies to a wide range of documents, including contracts, agreements, notes payable, capital contributions, letters of credit, and letters of guarantee, financial statements, and payrolls. Stamp duty is levied as a percentage of the value of the document at rates ranging from 0.15 percent to 0.75 percent.

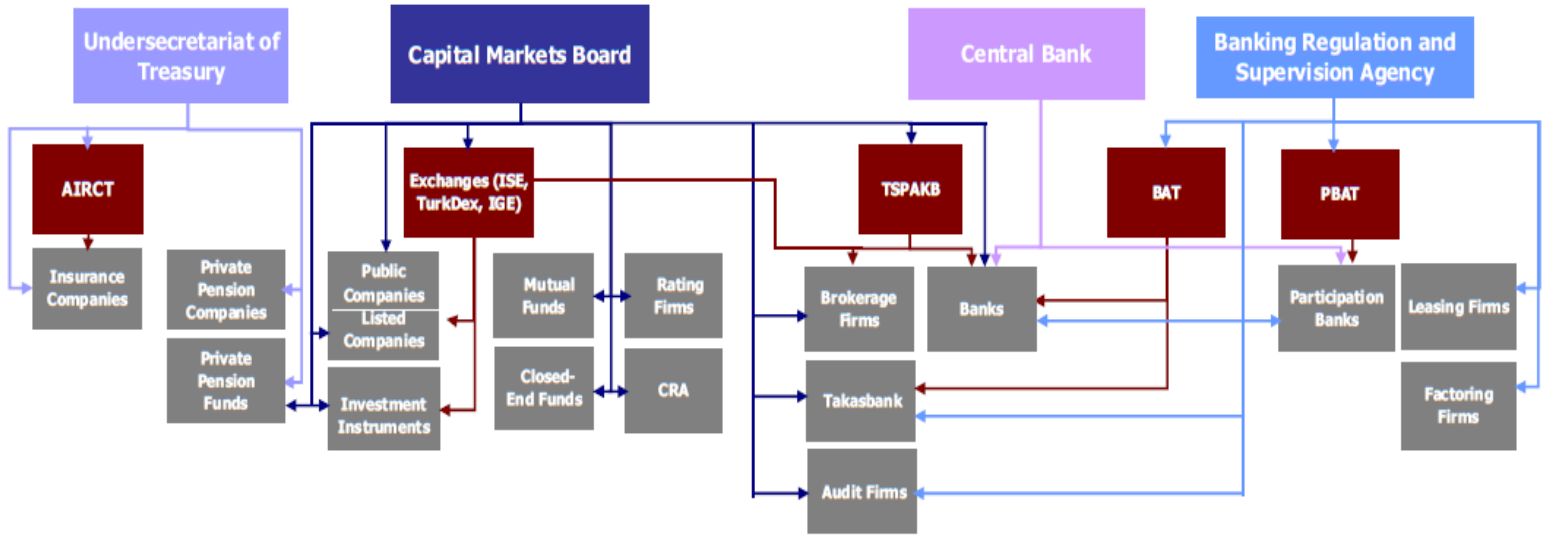
Tax Treatment for Bonds

Process	Tax Treatment
Issuance	• Transfer taxes and stamp duty - Stamp duty is levied as a percentage of the value of the document at rates ranging from 0.15 percent to 0.75 percent.
Trading & Investment	• To the extent that debt securities consist of Turkish government obligations (Treasury Bills, Government Bonds or cross-border Eurobond issues by Turkey), the related capital gains and interest income are exempt from taxation. • Capital gains and interest income arising from bonds issued by private law entities in Turkey are subject to taxation unless such bonds are (i) issued in Turkey and duly registered with the CMB; and (ii) the related income is derived by *duly regulated* resident or similar non-resident financial investors (investment funds, asset management funds, sovereign wealth funds, etc.). • Interest income and capital gains tax from corporate bonds are subject to 10 percent withholding tax for domestic investors and foreign individual resident investors. • Gains from trading activities by intermediaries are subject to tax. *Need to eliminating the 5 percent BITT currently applied on coupon income and capital gains for financial institution investors in an effort to level the playing field between various financial instruments and holders*

Tax Treaty

32. **The Turkish Government may reduce tax rates or exempt non-residents from taxes if there are tax treaties between Turkey and the country of the non-resident taxpayers.** Withholding tax on non-residents can be lowered in countries with a double taxation treaty (DTT). Different tax rates on interest, dividends and capital gains may be applied, depending on the tax treaties. When tax treaties clash with domestic tax laws, the tax treaties govern arrangements.

REGULATORY STRUCTURE OF THE TURKISH FINANCIAL SYSTEM



AIRCT: The Association of the Insurance and Reinsurance Companies of Turkey
BAT: Banks' Association of Turkey
CRA: Central Registry Agency
IGE: Istanbul Gold Exchange
ISE: Istanbul Stock Exchange
PBAT: Participation Banks' Association of Turkey
Takasbank: Settlement and Custody Bank
TSPAKB: The Association of Capital Market Intermediary Institutions of Turkey
TurkDex: Turkish Derivatives Exchange