WORLD ECONOMIC FORUM

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White Paper

Accelerating Capital Markets Development in Emerging Economies

Country Case Studies

May 2016

Prepared in collaboration with Oliver Wyman

Contents

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Preface

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The World Economic Forum is pleased to release the *Accelerating Capital Markets Development in Emerging Economies: Country Case Studies* White Paper, a second report from our Accelerating Capital Markets Development in Emerging Economies initiative.

Today, the consensus view remains that establishing capital markets is a long, drawn-out process because it requires step-by-step establishment of financial instruments, regulatory and legal frameworks, market infrastructure, and the establishment of a critical mass of market participants. Yet despite the challenges that can make the development of deep capital markets so complicated, many emerging economies no longer have the option to postpone or neglect their capital markets development. While they already represent half of global gross domestic product, their capital markets remain significantly underdeveloped relative to their economies' current size and future potential. Moreover, in the post-financial-crisis world, regulatory reforms and the investment environment have eroded the banking sector's ability to fulfil roles it has traditionally assumed. This requires new actors who can promote economic growth, unlock new pools of investment capital and finance the next generation of infrastructure.

In this context, the World Economic Forum established the Accelerating Capital Markets Development in Emerging Economies initiative in 2014, which asked the questions of if and how this process could be accelerated. The goal was to provide a platform for strategic dialogue, in which policy-makers and market participants could openly express their vision for capital markets development, considering in particular the development of market infrastructure, the roles of market enablers and intermediaries, and the impact of policy reform and legislative action. This remains a core aim of the initiative; it continues to bring different stakeholders together to create a discussion that can gather and disseminate best practices and knowledge across emerging economies.

In April 2015, the Forum released the initiative's inaugural report, *Accelerating Emerging Capital Markets Development: Corporate Bond Markets*, which outlined a practical set of recommendations for policy-makers to consider as they navigate the corporate bond market development process. With this foundation in place, the Forum launched dialogues in Colombia and Indonesia in 2015 to develop concrete initiatives within a specific country context that could stimulate the development and growth of these markets. Partnering with each country's ministry of finance, these dialogues included participation of large domestic players, foreign investors and other regulatory institutions to ensure a truly multistakeholder approach.

This White Paper presents a summary of the main conclusions and lessons learned from these efforts. It highlights key obstacles that prevent the development of deep and liquid capital markets in the Colombian and Indonesian contexts, and defines measures suitable for overcoming these challenges. While the insights are particularly relevant to the countries examined, we believe that some of the common themes and best practices are relevant across geographies. And though many of the recommendations are intended to be broadly applicable for navigating the capital markets development process, they are most relevant for emerging markets.

We hope that policy-makers in emerging economies and other key market participants will find these recommendations and best practices valuable as they steer through the challenging process of developing robust capital markets. As always, we welcome feedback from readers of this White Paper, and look forward to developing this important initiative further in collaboration with our knowledge partner, Oliver Wyman.

Executive Summary

Capital markets play a critical role in economic development by pooling domestic savings and mobilizing foreign capital for productive long-term investment. However, in many emerging economies, which currently represent about half of global gross domestic product, capital markets remain underdeveloped or are altogether non-existent.

With emerging economies projected to grow strongly over the next decade, the near-term development of deep and liquid capital markets will be necessary to fund future growth and ensure the competitiveness of those economies globally. Tightened restrictions for the banking sector (including the Basel III reform measures) are pressuring banks to retain additional liquid capital, decreasing their ability to provide loans and making other channels increasingly important for attaining financing. While many countries also face tremendous infrastructure financing gaps, the development of capital markets will enable a new pool of capital to be unlocked for unfunded infrastructure projects.

Context

Over the past year, the World Economic Forum initiated country-specific, high-level discussions on the development of capital markets in several countries. In each one, the Forum encouraged public-private dialogue, with the goal of identifying key barriers to development and defining measures suitable for overcoming existing challenges.

The initiative focused on Colombia and Indonesia, with the aim of promoting concrete initiatives to spur development and growth of each country's local market. The Forum conducted extensive interviews with market participants and co-hosted high-level private roundtable events in both Bogota and Jakarta in December 2015. These events brought together a select group of stakeholders (including public-sector representatives, institutional investors, and local and foreign intermediaries) to develop perspectives on the development of capital markets in each economy.

High-Level Findings

While every economy has its own characteristics, challenges and priorities, some universal best practices emerged from these discussions:

a. **Transparency and confidence in market mechanisms are essential.** A strong and stable regulatory and legal framework is fundamental for providing market participants with the confidence to enter the market. A strong institutional framework should lay out robust corporate governance standards and protect both issuers' and investors' rights. This framework should supply clear legal guidance on how business is conducted and what happens in cases of bankruptcy. Furthermore, market participants require clarity on accounting standards, disclosure and other reporting requirements. Lastly, to allow for effective and efficient price discovery, credible credit ratings should exist and investors must have access to relevant company information and data.

b. **Attractive and diverse investment opportunities must be available.** The issuer community must create a sufficient pool of attractive products for investors. In many emerging markets, investors willing to participate often discover that offered securities are insufficient in volume and breadth to meet their investment needs. To spur the creation of additional investment opportunities, emerging markets can eliminate obstacles that prevent businesses from issuing (e.g. address long and burdensome issuance processes).

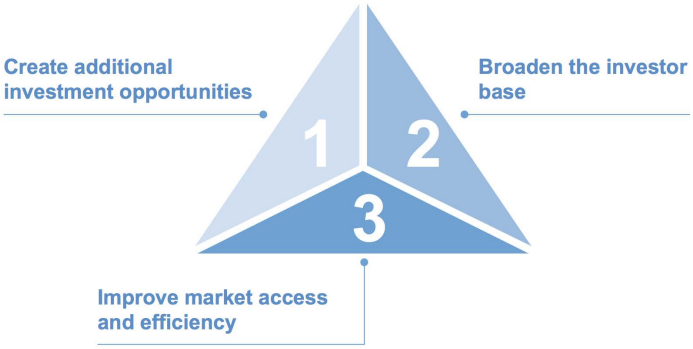
c. **Diversification of investors is crucial.** Stable and well-functioning capital markets require a broadly diversified investor base. Capital inflows to emerging markets can increase market liquidity, and foreign investors frequently provide pressure for reforms during a market's early development stages. At the same time, domestic investors often provide stability to the market as geopolitical changes and other macroeconomic conditions can trigger rapid outflows of foreign capital. Separately, retail investors create demand in core markets, such as for bonds and stocks, while institutional investors support the development of more complex financial products.

d. **Financial education of investors and issuers promotes market participation.** Insufficient financial education can significantly hamper development of a country's capital markets. Before deciding whether to issue financial products, potential issuers must understand the issuance process and the options available to them (e.g. types of products, corporate governance set-ups). Similarly, potential investors must understand how financial markets function and the risk-return profiles attributed to different financial products. Without this basis, investors are more likely to suffer unanticipated losses and lose confidence in financial markets.

While this White Paper attempts to address the many opportunities applicable across emerging countries, each country is different, with varying structural constraints, financial development histories and political backgrounds. The case studies are intended to further explore Colombia's equity market and Indonesia's corporate bond market, highlighting obstacles and solutions specific to each.

Rather than providing an exhaustive list of all challenges and solutions uncovered, the two case studies are structured around three shared objectives for improving the efficiency and effectiveness of capital markets in emerging economies:

1. **Create additional *investment opportunities*** by encouraging increased issuer participation through (a) optimized issuance processes and procedures and (b) economic policies that encourage tapping into capital markets.
2. **Broaden the *investor base*** by improving the investor value proposition via (a) reforms that encourage both foreign and domestic investments, (b) tax regimes that align with financial development objectives, (c) strengthened regulatory and legal frameworks that protect investors, and (4) strong corporate governance frameworks.
3. **Improve *market access and efficiency*** by (a) improving data collection and dissemination, (b) enhancing competitiveness of the market infrastructure and the financial intermediation industry, and (c) developing and growing standard types of products and transactions (e.g. repurchase agreements, securities lending and equity derivatives).



Source: Oliver Wyman

Background

In 2014, the Forum established the Accelerating Capital Markets Development in Emerging Economies initiative, with the aim of encouraging a dialogue that could create new knowledge and aggregate best practices across emerging economies. From 2014 to 2015, the initiative explored how to make the process for developing and deepening corporate bond markets more effective and efficient, culminating in the initiative's first report, *Accelerating Emerging Capital Markets Development: Corporate Bond Markets*, published in April 2015.

This White Paper offers a practical set of recommendations (Figure 1) in four action categories for policy-makers navigating the corporate bond market development process. It provides an overview of those markets, establishing the key role they play in the financial system and overall economic development, and highlights the numerous challenges and extensive effort involved in developing them. The White Paper outlines recommended policy actions for overcoming some of the key challenges and accelerating corporate bond market development, highlighting select actions that are potentially the most impactful.

The White Paper's recommendations are grouped into the following action categories:

A. **Encourage greater issuer participation:** How to minimize the obstacles for issuers to the market and the relative costs to participate in it

B. **Improve the investor value proposition:** How emerging markets can encourage the development of a domestic savings pool and lower actual and perceived risks of participating in the market for domestic and international investors

C. **Enhance market efficiency and transparency:** How to enhance market infrastructure and intermediary activities to lower the burden and costs associated with participating in the market, and to match supply and demand more effectively

D. **Attract global interest:** How to establish a national direction for market development and improve the domestic market's attractiveness relative to global markets

These four categories mirror the three common objectives that group the case studies' challenges and solutions. In the framework of the objectives, namely (1) to create additional investment opportunities, (2) to broaden the investor base and (3) to improve market access and efficiency, the action category "attract global interest" is touched upon in both the second and third objectives.

Figure 1: Case study action categories, recommendations and outcomes

Action category	Key recommendations	Key outcomes
A. Encourage greater issuer participation	1. Limit market distortions that bias against corporate bond markets 2. Optimize the issuance process and costs – Streamline issuance processes – Expand issuance options to cater to a diverse set of corporations – Harmonize the regional issuance framework	– Expand access to and use of corporate bond – Lower the cost of financing – Improve efficiency and time to market
B. Improve the investor value proposition	1. Introduce reforms to encourage domestic long-term savings – Encourage an investment culture through education – Provide incentive for or mandate private domestic savings 2. Strengthen the regulatory and legal framework to offer credible investor protection – Develop an effective and efficient process for settling disputes – Strengthen the insolvency regime 3. Establish a strong corporate governance framework	– Grow the size of the local capital pool – Improve market certainty and investor confidence in entering the market – Improve recovery rates
C. Enhance market efficiency and transparency	1. Improve information availability and accuracy – Establish robust accounting and reporting standards – Improve collection and assimilation of market data 2. Enhance the competitiveness of market infrastructure and intermediaries – Minimize fragmentation in market infrastructure – Ensure market infrastructure is competitively positioned – Develop a sophisticated and competitive environment for financial intermediation	– Improve the ability of market participants to assess the market's costs and benefits – Match capital supply with demand more effectively – Increase secondary market liquidity
D. Attract global interest	1. Form and communicate a clear strategy for developing capital markets 2. Implement a tax regime aligned with financial development objectives 3. Position country to be included in global indices and portfolios	– Increase exposure in the global emerging market portfolio – Be better positioned to serve as a financial centre

Sources: World Economic Forum; Oliver Wyman

The following conditions are required for successfully implementing the recommendations:

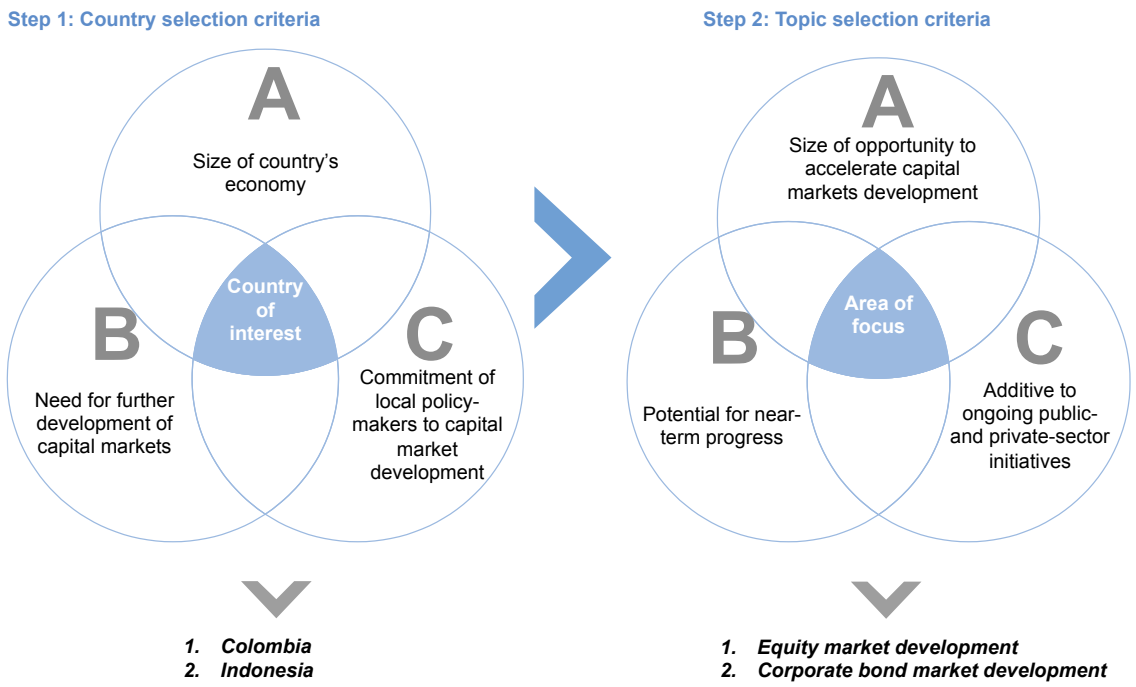
- **Macro-fundamentals have been established and/or are being addressed.** These include sustained macroeconomic and political stability, capital account liberalization, the fundamental rule of law, a strong institutional framework and a sound banking system.
- **The government is committed to the corporate bond market development process.** Government sponsorship has supported successful examples of developing emerging-market corporate bond markets.
- **The government's policy actions are communicated clearly and applied consistently.** While investors are able to account for known market risks and price accordingly, unpredictability of doing business in a country dissuades them from entering altogether.

Furthermore, ongoing partnership and dialogue with private-sector market participants is important for an effective market development process. Policy-makers should be reactive to the market and adapt as needed if unintended consequences of new regulations or reforms appear to adversely affect market participants.

Methodology for market selection

The Forum employed a two-step selection method (Figure 2) to determine where to focus its efforts over the past year. To create a shortlist of potential target countries, three criteria ensured a high likelihood of impact: (a) the size of the country's economy, (b) the need for further development of capital markets and (c) the commitment of local policy-makers to capital market development. Ultimately, collaborations were launched in Colombia and Indonesia given the Forum's strong relationships and local policy-makers' high level of interest shown in the Forum's initiative. Next, as the topic of capital market development is very broad, each country had a specific area of focus within capital markets development. Working with local policy-makers, the Forum decided to concentrate on development of Colombia's equity market and Indonesia's corporate bond market, based on the following three criteria: (1) the size of the opportunity to accelerate capital markets development, (B) the potential for near-term progress and (C) the potential to be additive to ongoing public- and private-sector initiatives. The country case studies include additional details relevant to the topic selection.

Figure 2: Two-step method for selecting countries



Source: World Economic Forum

I. Case Study: Colombia's Equity Market

Background

Latin America's capital markets have grown rapidly in recent years. The total stock market capitalization has more than quadrupled over the last decade, with Brazil, Mexico, Chile and Colombia representing the largest markets for equities. Similarly, bond markets have grown steadily across the region, with government bonds making up the majority of the market.

Activity in government debt and equity markets dominates Colombia's capital markets, with the corporate bond market trailing behind. The government bond market has flourished since its development in the 1990s, and is widely perceived to be a well-functioning and liquid market. In contrast, several major obstacles impede the further development and growth of Colombia's corporate bond market and equity market. Though issuances have risen in recent years, the corporate bond market remains underdeveloped, has low liquidity and is dominated by financial-sector issues. To address these and other issues, the stock exchange has launched an initiative to revive the market by encouraging ongoing dialogue with policy-makers. As these efforts are already under way, the Forum has focused its collaboration with the Colombian Ministry of Finance on the development and deepening of the stock market.

Over the past decade, the Colombian equity market experienced significant growth, with market capitalization increasing from 34% of gross domestic product (GDP) in 2005 to 73% in 2012 (Figure 3a). Driving this rapid development were strong economic growth, development of the private pension system, increased interest from foreign investors, as well as large democratization programmes that produced a number of landmark initial public offerings and the development of a retail investor base.

However, in the context of a challenging macroeconomic environment, the Colombian equity market has seen a substantial decline in stock prices since 2012, with market capitalization declining to 35% of GDP in 2015 (Figure 3b). In addition, liquidity in the local market has significantly declined and is among the lowest among peer emerging economies. Colombia's stock exchange, the Bolsa de Valores de Colombia (BVC), began trading shares in 2007 and experienced an average turnover ratio of only 13% in 2012-2015 (Figure 4a, 4b). This lack of liquidity increases transaction costs for market participants, prevents participation of certain investor types and increases risks (namely, systemic and liquidity).

Figure 3a: Market capitalization of the Colombian stock exchange
In COP TN and as a % of GDP

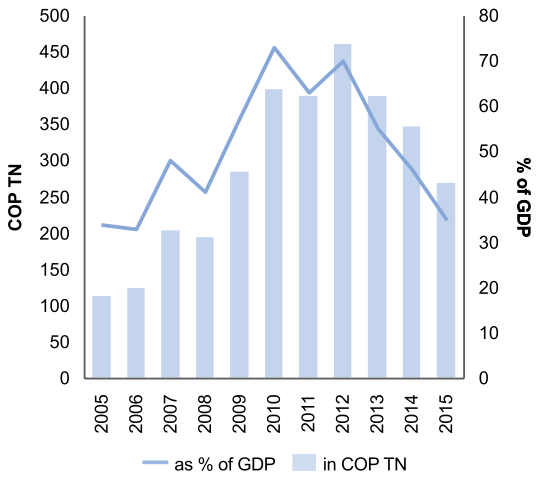
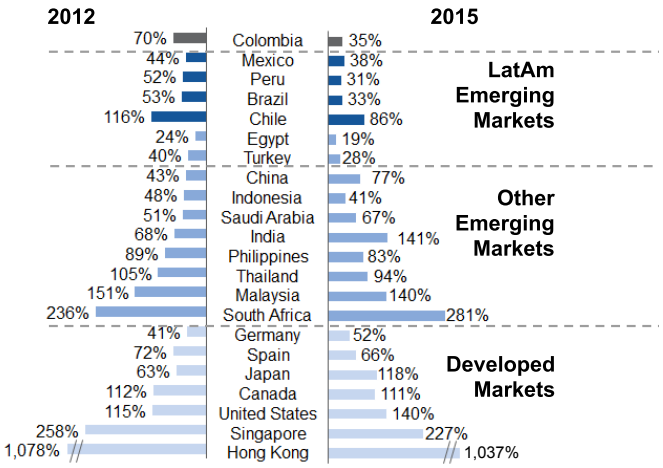


Figure 3b: Market capitalization of key markets
As a % of GDP



Note: COP TN = Colombian pesos, in trillions
Sources: Bolsa de Valores de Colombia, World Federation of Exchanges, World Bank, International Monetary Fund

Figure 4a: Annual turnover ratio[1] Colombian stock exchange

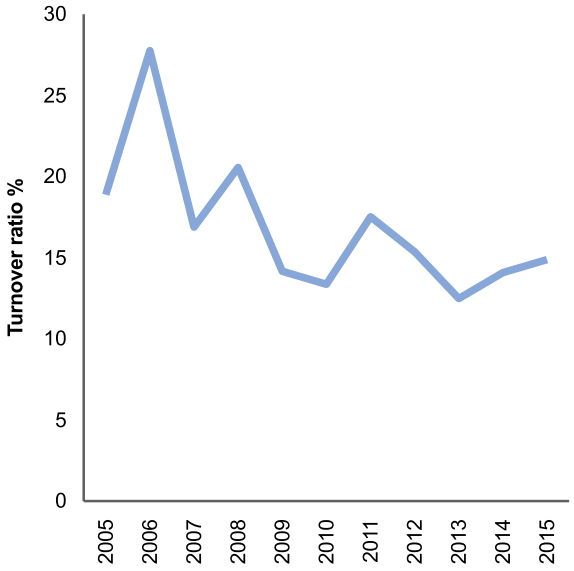
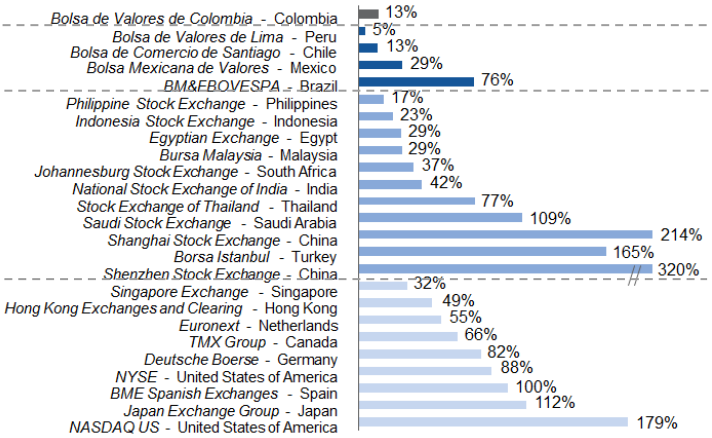


Figure 4b: Turnover ratio[1] of key stock exchanges
Average of 2012-2015



[1] Measured as: annual value of share trading in the electronic order book (e.g. excludes negotiated trades and reported trades) over total market capitalization. Excludes trading of domestic shares in foreign exchanges
Sources: Bolsa de Valores de Colombia, World Federation of Exchanges

Due to these recent trends and their implications, the depth and liquidity in Colombia's local equity market is a key area of focus for Colombian policy-makers and market participants alike. Despite measures undertaken in recent years, further efforts must be taken to develop Colombia's equity market in the near term.

Roundtable

On 3 December 2015, in coordination with Colombia's Ministry of Finance and Public Credit, as well as the Unit for Financial Regulation, the Forum hosted a private roundtable in Bogota focusing on the development and deepening of the Colombian equity market.

01: Keynote speaker Mauricio Cardenas, Minister of Finance and Public Credit of Colombia (Bogota roundtable)

Key Challenges and Opportunities

Within this context, stakeholder groups discussed how the equity market in Colombia could be further developed. Several opportunities and key challenges emerged from the discussion, as well as from interviews held prior to the roundtable:

1. Investment opportunities

The limited number of investment opportunities is a primary barrier to deepening and developing the Colombian equity market. First, the number of issuers is low relative to peers: as of December 2015, Colombia had only 73 companies listed on its stock exchange (Figure 5a). In addition, Colombia's stock market is dominated by only a few companies, including Ecopetrol, the state-run oil company that accounts for nearly 45% of the total market capitalization. Furthermore, compared to peer economies, the Colombian equity market has a very low level of free float, at 29% as of 2014 (Figure 5b). A low level of free float can threaten the market's liquidity and discourage investor participation.

Efforts to attract new issuers into the market and encourage currently listed companies to increase the level of free float will be crucial to the market's development. Several potential opportunities include:

A. Promoting issuer education

Businesses are more likely to issue stocks and/or bonds if they are educated on the processes for and advantages of issuing financial products. The BVC's efforts to educate issuers through the Colombia Capital programme should be continued and expanded. In Colombia, where a substantial

Figure 5a: Number of companies listed in LatAm exchanges[1]
As of December 2015

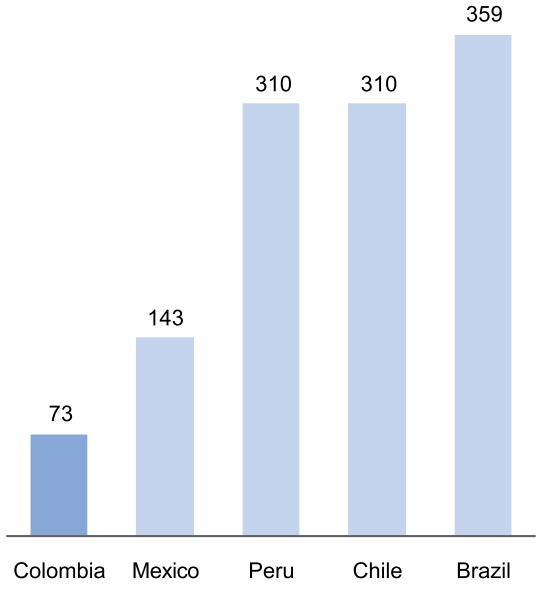
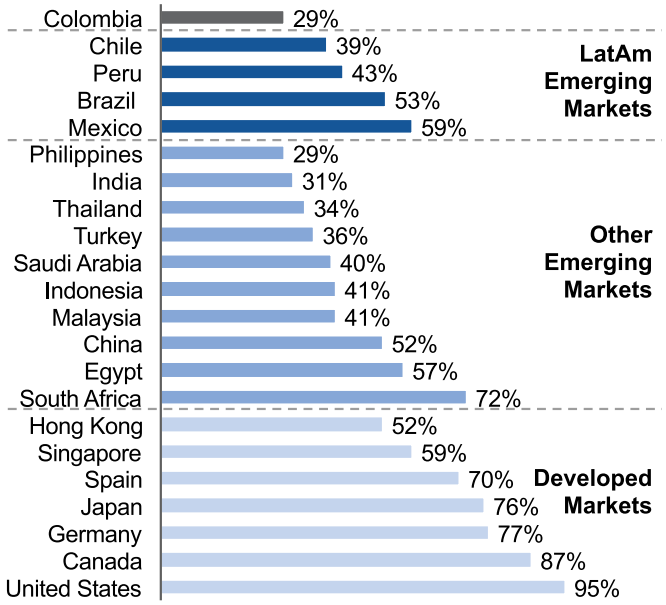


Figure 5b: Average free float ratio
As of 2014



[1] Includes domestic and foreign companies listed on domestic exchanges
Sources: Bolsa de Valores de Colombia, World Federation of Exchanges, Credit Suisse Research, Capital IQ

percentage of businesses have been family-owned or run for generations, issuer education is particularly important because family-business owners may be reluctant to tap into capital markets due to fear of increased reporting requirements and cession of control over their company to outside investors. Once these business owners fully understand the disclosure and reporting requirements, and the options for maintaining greater control of their companies (e.g. issuing preferred shares), they may decide that the benefits of issuance outweigh the drawbacks. In addition, developing the family office sector could provide new alternatives for wealth generation once a family business has been listed, reducing reluctance of these businesses to tap into the equity market.

B. Addressing the burden and cost of issuance versus bank funding

Many Colombian businesses have received funding from the country's robust banking market. Few have accessed the local capital markets because bank loans are frequently more attractive economically and less burdensome than issuances. In order to attract more issuances, policy-makers could consider a number of changes. First, they should continue to explore opportunities for accelerating the approval process for the issuance of securities. In particular, policy-makers could further simplify requirements and reduce costs in the small and medium-sized enterprise (SME) market to create a market that competes with traditional bank loans for smaller businesses. Many countries have successfully created specific market segments for SMEs within their main exchanges, with relaxed listing and disclosure requirements and lower costs (e.g. South Korea, Malaysia, Thailand, Singapore, India, China, Hong Kong, South Africa). Second, they could encourage and provide incentives for large companies that are already issuing bonds to also issue stocks, given that they already largely comply with various reporting requirements. Lastly, many of Colombia's flagship issuances over the last decade were "democratizations" targeted to the mass retail market. This approach to issuance had the unintended consequence of increasing costs for issuers. Thus, this approach should be reconsidered and some issuances could instead be targeted primarily to professional investors, which can then offer those securities to the retail market.

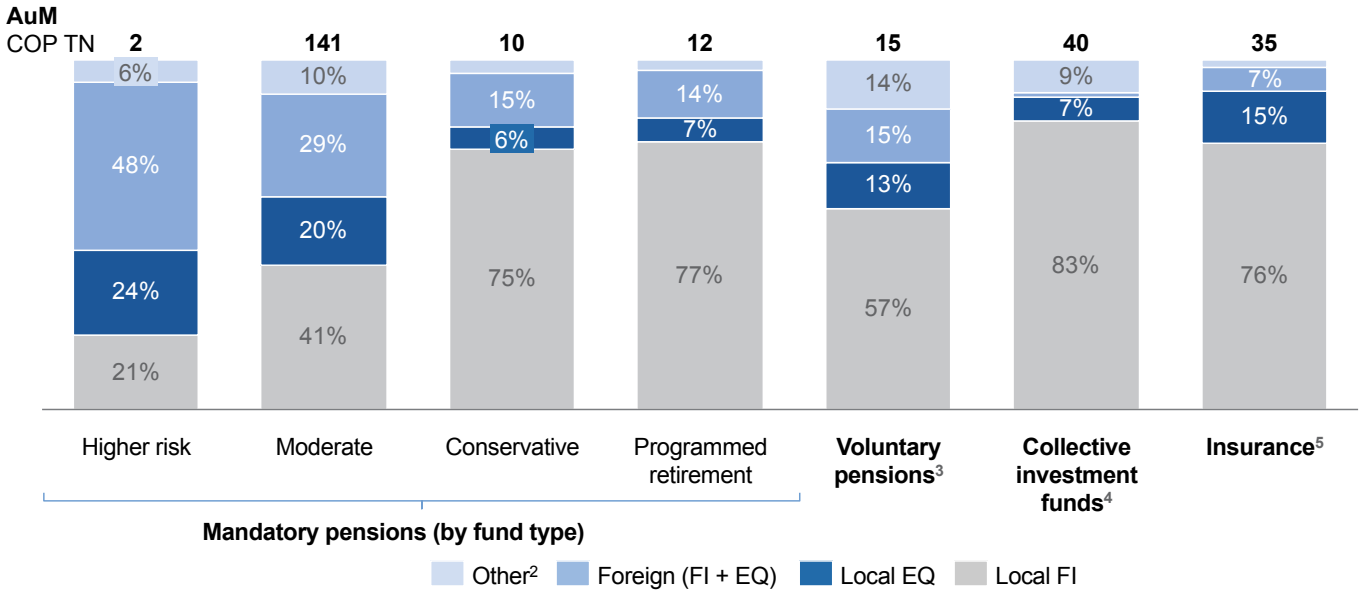
C. Improving corporate governance

Despite significant efforts to improve corporate governance standards of both listed companies and potential issuers, some challenges remain which may be limiting willingness to invest in the market. In particular, strengthened protection of minority shareholder rights is needed for issuers to attract interest from a broad set of local and foreign investors.

2. Investor base

While Colombia has made significant progress in developing a local investor base (Figure 6), potential exists to increase the pools of domestic capital available for deployment. The mandatory Colombian private pension system accounts for the bulk of assets under management (AUM) in Colombia. The equity market could benefit from a larger and broader investment base and, specifically, from additional shorter-term investors with more speculative strategy.

Figure 6: Asset allocation in Colombia by type of local institutional investor
% of total AuM, as of july 2015[1]



Note: FI = Foreign investment; EQ = Equity
1. As of September 2015 for collective investment funds
2. For mandatory and voluntary pension funds, "Other" includes private equity, derivatives and deposits; for collective investment funds, "Other" includes non-rated debt, real estate and specialized funds
3. Includes voluntary pension funds managed by pension fund administrators, trusts and insurance companies
4. Excludes private equity funds and funds managing public resources under Decree 1525
5. Includes life and non-life insurance
Sources: Superintendencia Financiera de Colombia, Carteras Colectivas

The following approaches, categorized by investor segment, could broaden the investor base:

A. Pension funds

Colombia has a dual pension system in which public and private funds coexist. While the country's private pension system dominates the local market, pension funds use a buy-and-hold investment strategy, and thus cannot be expected to provide significant market liquidity. However, scope still exists for policy-makers to consider reviewing regulations in the pension fund sector. For example, Colombia subjects pension funds to relative profitability rules, which require funds to achieve rates of return above a prescribed minimum. These minimum return requirements limit risk differentiation and have created herd-like behaviour among pension funds. Altering these requirements could not only lead to greater differentiation among pension fund providers, but also allow these funds more independence when making investment decisions. Separately, government pension mandates, such as Fondo Nacional de Pensiones de las Entidades Territoriales (commonly known as FONPET), could invest more actively in the local equity market.

B. Banks

Banks are currently restricted from participating in the equity market. Allowing them to participate as investors and intermediaries in the equity and index derivatives markets could help greatly to develop the market, given that banks have greater access to liquidity. Adequate controls and restrictions on their participation will mitigate risks associated with their expanded role in the markets.

C. Insurers

As already mentioned, pension funds are by far the most relevant local institutional investor, and the Colombian market (and economy more broadly) would benefit from the development of new local institutional investors. Specifically, insurance firms could play a critical role in further developing the local equity market. Policy-makers could promote participation of insurers in the equity market by developing the annuities sector.

D. Mutual funds

Recent changes to the regulatory framework for mutual funds have set the stage for the development and specialization of this industry. The sector's development could lead to a wider range of investors with a broader suite of professionally-managed capital market products, rather than funds largely invested in CDs and other banking products. Mutual funds could benefit from improving customer segmentation based on risk profile and other characteristics (e.g. investment objectives based on age); this would ensure that product offerings and channel strategies are aligned with the needs and wants of different types of investors.

E. Hedge funds and other professional investors

New risk-taking investor groups need to be developed to expand liquidity in Colombia's equity market. Developing hedge funds and other professional investors will require regulatory changes that enable and encourage risk-taking. Lastly, family offices could provide a suitable pool of capital for developing hedge funds and other nascent investor types and asset classes.

F. Retail investors

Over the last decade, "democratization" programmes largely drove participation by retail investors. While these programmes successfully attracted interest from the mass market, they also led to low diversification in retail investor portfolios (as these are typically concentrated in a few names), which triggered a loss of confidence following the decline in commodity stocks. To restore investor confidence and increase retail activity in the equity market, comprehensive financial education for retail investors will be critical. That education needs to emphasize the safety of financial markets and describe the risk profiles attributed to different financial products. The emerging mutual fund industry and the development of a specialized financial advisory sector could provide the products and guidance to better serve investors' risk affinities (including an expanded and more diversified suite of product offerings and additional channels for product distribution).

Importantly, tax regimes that align with financial development objectives, robust regulatory and legal frameworks that protect investors, and strong corporate governance standards will help attract investors across all segments. Separately, with regard to asset managers and financial advisers, an improved suite of products and services will help these firms better serve both existing and new customers, as will further professionalization, training and specialization of analysts, portfolio managers and sales forces.

3. Market access and efficiency

Despite significant development over the past decades, some operational and regulatory challenges still constrain access and efficiency in the Colombian equity market. For this market to continue growing, Colombia's risk culture needs to evolve, recognizing that risk is inherent in capital market activities. Therefore, all market stakeholders need to strengthen risk management practices rather than create restrictions that can stymie further development of the market. Several potential opportunities include:

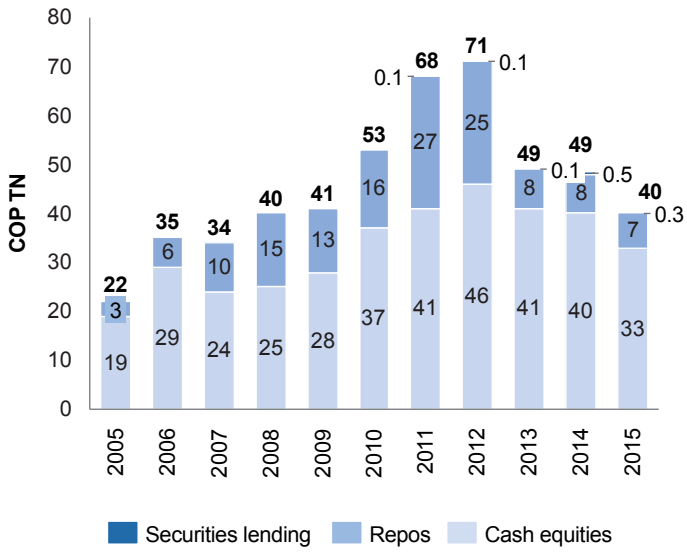
A. Encouraging facilitation by firms to enhance liquidity

Rather than promoting a more robust risk management culture, certain operational and regulatory requirements in Colombia limit market size as a way to mitigate risks. However, volume and market size are not necessarily the best indicators of inherent risk. Increased regulatory restrictions on transactions that require leverage may be limiting the market's ability to reach its potential, and policy-makers should continue to review limits that may be unnecessarily restrictive (work is currently in progress to review restrictions in Decree 2878). In order to protect market stability and integrity, solid risk management practices within the industry must accompany any liberalizing of leverage restrictions.

B. Further developing repurchase agreements, securities lending and derivative markets

Certain standard types of products and transactions, such as repurchase agreements (repo), securities lending and equity derivatives, are currently less developed in Colombia than in peer emerging markets, and Colombian equity market volumes have declined since 2012 (Figure 7). Further developing repo, securities lending and equity derivatives would improve market operations, facilitate market-making activities (e.g. short selling of securities) and expand the universe of investment and hedging strategies available to market participants. Enabling custodians to lend securities, allowing securities-lending transactions to be conducted as back-office over-the-counter operations (standard practice in other markets), and reducing administrative and compliance requirements for securities lending could simplify operations, reduce costs and encourage broader participation in the securities-lending market. Lastly, the local equity market could expand through the growth of investment vehicles for tax-efficient investment in real estate, energy and infrastructure (e.g. real estate investment trusts, master limited partnerships, Mexico's infrastructure and real estate trusts [FIBRAs]), as well as the development of options and other hedge products.

Figure 7: Equity market volumes by type of transactions in Colombia
2005-2015, in COP TN



Sources: Bolsa de Valores de Colombia, Bank of England, Banque du Canada, House of Finance

C. Increasing transparency and flexibility in the foreign exchange market

Creating further transparency, decreasing trading restrictions and improving flexibility in the foreign exchange market could promote participation of a wider range of players and be beneficial in developing the local equity market.

D. Encouraging access for foreign investors

Colombia should build off its past and current efforts to improve the local investment environment within a global context. For instance, providing key regulatory and financial information in English (e.g. regulatory texts, investment prospectuses, company-related information, credit ratings) would increase ease of access for foreign investors. In addition, shortening the time needed by foreign investors to open an account – for instance, by simplifying the investor ID scheme – and enabling foreign investors to clear in US dollars, even if temporarily, could also facilitate processes for investors to enter the Colombian market.

E. Decreasing transaction costs

Two key opportunities that could generate cost efficiencies in Colombia's equity market are (1) achieving greater economies of scale through further horizontal and vertical integration of infrastructure providers, and (2) decreasing regulatory compliance costs. Various markets have already promoted vertical and horizontal integration of infrastructure providers (e.g. Germany, Spain, Canada, Brazil, Singapore).

F. Simplifying tax operations

Further simplifying such operations would create greater clarity and efficiency for investors and intermediaries.

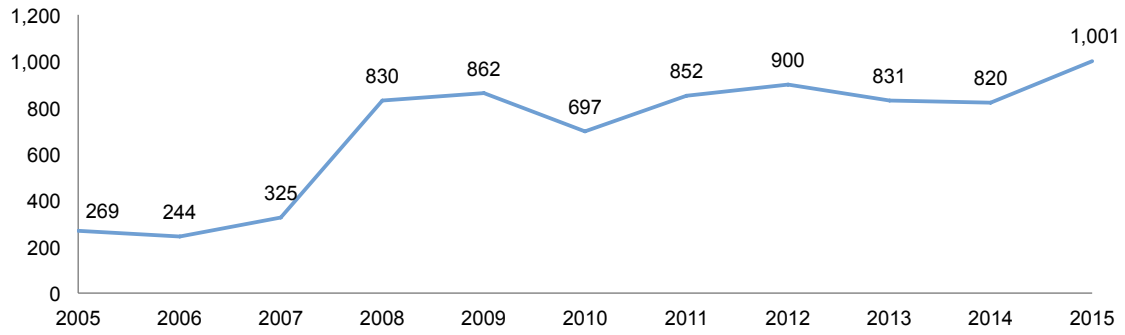
II. Case Study: Indonesia's Corporate Bond Market

Background

Indonesia is at an inflection point concerning capital market development. Extensive research has established the correlation between financial market development and economic growth. According to the 2015 report, *Financial Deepening in Indonesia: Funding Infrastructure Development – Catalyzing Economic Growth*, published by the Mandiri Institute (Indonesia) and Oliver Wyman, the country has the potential to become one of the world's top-seven economies by 2030 with full reform and accelerated development of its capital markets. However, at the current pace of reform, Indonesia likely will be unable to fund the ambitious economic growth required and will probably fail to break into the top 10 economies.

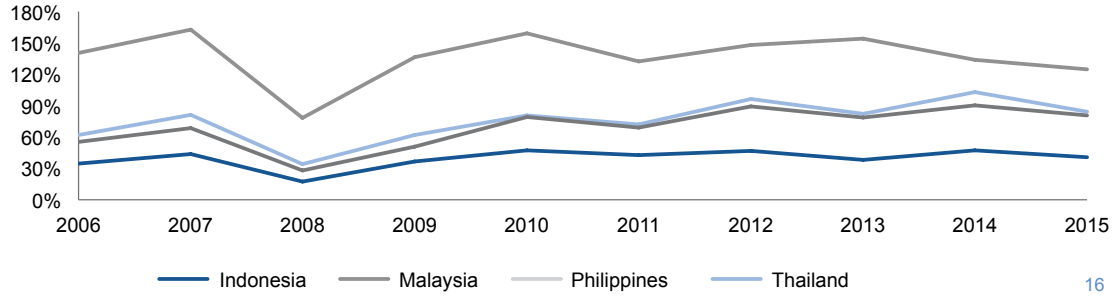
Financial deepening has been an active discussion topic in Indonesia for the last decade, as demonstrated by the roughly 800 articles on the topic published annually in the country (Figure 8). However, progress has been slim. Despite strong GDP growth over the last 10 years, development of financial markets has lagged and is low compared to similar emerging markets in the Association of Southeast Asian Nations (ASEAN), namely Malaysia, the Philippines and Thailand. In addition, the relative depth of Indonesia's financial markets – as measured by the ratio of stock market capitalization and volume of outstanding corporate and government bonds to GDP – has been roughly flat over the last 10 years, while regional peers have made progress in deepening their financial markets (Figure 9a, 9b, 9c).

Figure 8: Number of articles on "Financial deepening in Indonesia"



Source: Factiva search results

Figure 9a: Stock market capitalization to GDP



16

Figure 9b: Government bond market capitalization to GDP

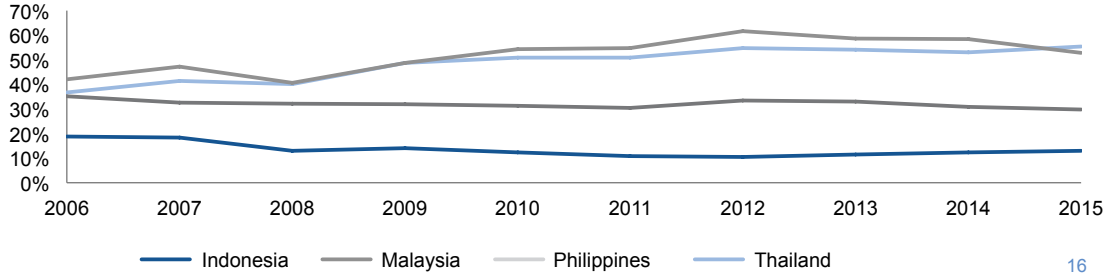
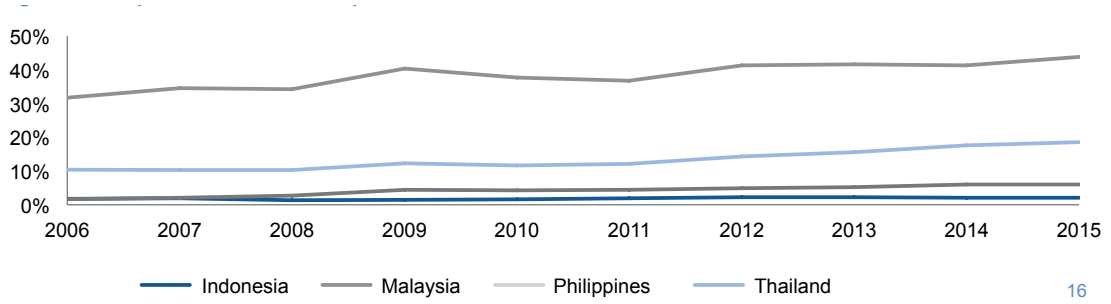


Figure 9c: Corporate bond market capitalization to GDP



Sources: ADB AsianBondsOnline, The Economist Intelligence Unit, World Federation of Exchanges

The equity market has grown rapidly in ASEAN. Malaysia continues to have the largest stock market capitalization as a percentage of GDP, at 125% as of 2015, followed by Thailand (84%) and the Philippines (80%). While the Indonesian stock market has grown recently, it still remains small in terms of market capitalization compared to Indonesia's economy (with a market capitalization of only 41% of GDP as of 2015). Malaysia also has the largest bond market of ASEAN emerging markets, and Indonesia has the smallest bond market relative to its own economy, with government and corporate bonds at 13% and 2% of GDP, respectively, in 2015. In Indonesia as in many emerging markets, the corporate bond market remains substantially underpenetrated. As a result, the Forum has focused its collaboration with Indonesia's Ministry of Finance on the development of the country's corporate bond market.

Indonesia's corporate bond market is plagued by a lack of depth and low liquidity, driven by a limited supply of quality issues, low retail participation, and buy-and-hold behaviour among domestic institutions. Because of these recent trends and their implications, the development of Indonesia's local corporate bond market is a key area of focus for both Indonesian policy-makers and market participants.

Roundtable

On 14 December 2015, in coordination with Indonesia's Ministry of Finance, the Forum hosted a private roundtable in Jakarta with participants from the country's government, domestic and foreign private-sector representatives, and international institutions. It focused on and was titled, *Accelerating Local Capital Market Development in Indonesia – Catalysing Economic Growth for the Future*.

01: Panel discussion on building and financing Indonesian infrastructure (Jakarta roundtable)

Key Challenges and Opportunities

Within this context, much interest was shown for establishing a multistakeholder dialogue on developing Indonesia's corporate bond market. A number of key challenges and opportunities for further development emerged from the discussions:

1. Investment opportunities

Indonesia's corporate bond market suffers from a limited supply of high-quality investment opportunities. The number of corporates issuing bonds on the Indonesian market has remained relatively stable over the last several years and, in terms of absolute number, is similar to Malaysia's (Figure 10a). In contrast, Thailand has seen increasing numbers of active corporate issuers. Furthermore, the volume of bond issuances for Indonesian corporates has been relatively stagnant since 2012. While aggregate debt capital market (DCM) deal volumes have increased over the past several years (Figure 10b), much of this increase has been driven by growth in government bonds.

Figure 10a: Number of active debt capital market (DCM) issuers
2010-2015

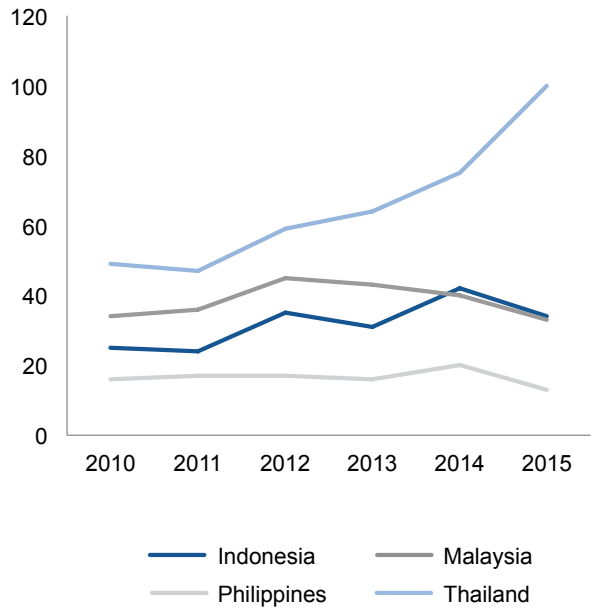
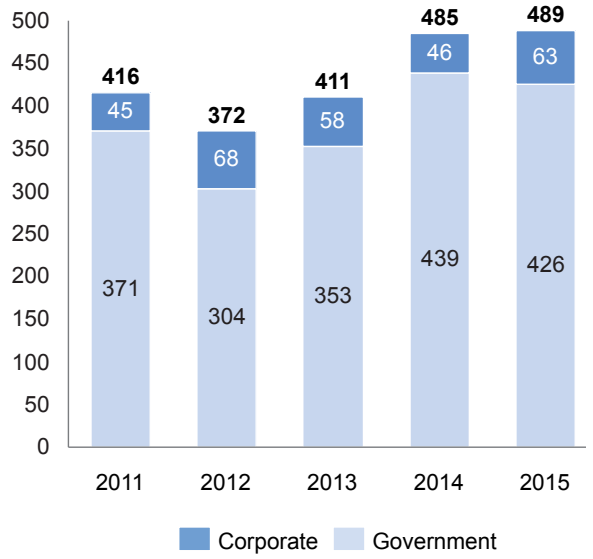


Figure 10b: Aggregate DCM deal volumes for Indonesia
IDR (Indonesian rupiah), in trillions, 2011-2015



Sources: Dealogic, ADB AsianBondsOnline

Several measures can help attract issuers and increase the number of investment opportunities, including:

A. Simplifying the issuance process

Many corporates do not access capital markets because the issuance process and disclosure requirements are too cumbersome. Policy-makers should strive to decrease the burden (regulatory and otherwise) of being listed. The time required to complete the bond issuance process in Indonesia can be four to six months. Many peer markets have gradually reduced approval times, mostly as part of concerted attempts to streamline the issuance process. The issuance approval time in most markets is under eight weeks, and bank loans can be approved even more quickly. Furthermore, documentation and disclosure requirements are extensive relative to other geographies or to the documentation required by banks for loans, discouraging potential issuers who fear higher tax payments. Lastly, reports are currently published under various accounting standards (e.g. US GAAP [generally accepted accounting principles], index discount rate GAAP). To streamline reporting, regulators could choose and enforce a specific accounting standard. An issuance process for corporate debt that is more efficient and less burdensome would likely attract additional issuers.

B. Improving the economics of issuing corporate bonds

Many potential issuers think the economics for issuing corporate bonds are less favourable than taking a bilateral loan from a bank. Currently, because regulators are funded by fees related to issuances, the transaction costs of issuing a corporate bond can be quite high. In addition, the extensive documentation and disclosure requirements, regulatory filings and shareholder communications also require additional resources, contributing to less attractive economics of issuance. When considering the future, Indonesia can look to other markets, where tax incentives on corporate bonds have attracted additional issuers (e.g. making issuance expenses tax-exempt).

C. Increasing issuer education

Another barrier to issuing corporate debt is a lack of knowledge about the process and implications of issuing financial products. Programmes that educate issuers about seeking funding in capital markets will ensure businesses are aware of an alternative to bank loans.

D. Further promoting corporate issuances

In order to attract credible corporate bond issuers, many emerging economies have encouraged state-owned enterprises (SOEs) to issue corporate bonds (e.g. South Africa). Indonesia could follow their example and identify SOEs that are priority candidates for listing. Separately, many corporates with lower credit rating, as well as SMEs, have difficulty raising funds by issuing bonds in Indonesian capital markets. In certain cases, policy-makers could enhance credit guarantee mechanisms for lower-rated bonds (e.g. infrastructure and SMEs) to make these viable investment opportunities for domestic and foreign investors. The governments of several peer markets, including Thailand, India, South Korea and Malaysia, have provided such credit guarantees.

2. Investor base

Indonesia's corporate bond market suffers from the absence of a strong investor base. The market has few individual investors in corporate bonds relative to other markets, and these investors are fairly inactive. The investor base could be broadened in the following ways, categorized by investor segment:

A. Banks

Banks' participation in corporate bonds is currently limited because of the legal lending limit, under which corporate bonds are included, that constrains banks' exposures to single borrowers and borrower groups. Banks are reluctant to invest in corporate bonds. Historical separations between corporate banking and treasury prevent the quick communication and coordination required for bank-wide use of legal lending limits needed for short-term investment decisions involving corporate bonds. Ultimately, banks should strive to break down such internal isolation. At the same time, if a corporate bond represents a market (vs credit) exposure and will be held for sale, it should not be included in the legal lending limit.

B. Pension funds and mutual funds

Active participation of both pension and mutual funds is critical to developing the Indonesian local market, especially as banks begin to face increasing capital and liquidity pressures. To encourage their participation, policy-makers should enable the pension industry to develop a longer-term mindset by changing the evaluation criteria to longer-term targets.

C. Insurers

Regulatory issues (e.g. capital charge) currently impede insurers from actively participating in the corporate bond market. With proper reform, insurers could jump-start the local corporate debt market.

D. Retail investors

Retail participation in Indonesian capital markets is lower than in peer countries, partly because individuals are comfortable with term deposits. Currently, retail investors are encouraged to hold cash in term deposits due to high bank deposit rates and the deposit insurance programme, but they receive no fiscal incentives to invest in long-term savings products. Policy-makers could consider offering tax exemptions for retail investments in capital market products, such as upfront exemption from taxable income up to a predefined ceiling. India provides retail investors with a number of exemptions for making capital market investments, which have been effective at bringing additional retail investors to the market.

To expand the pool of such investors, Indonesia could also consider the benefits of a targeted education programme that emphasizes the importance of longer-term investments and their advantages relative to term deposits, as well as the capital markets' ability to provide attractive and safe long-term investment opportunities. In addition, the market needs to better accommodate retail investors. High minimum ticket sizes for retail bonds (at 2 billion IDR) currently constrain the pool of potential investors, who have only a limited number of products available to them. Financial institutions should be empowered to create new products, as innovation in offerings should woo retail investors. Lastly, policy-makers could attract local investors by providing incentives for the mutual fund market. This has worked before, as taxes in Indonesia are attractive for mutual funds for government bonds – a market that is flourishing.

E. Foreign investors

Foreign investors are highly interested in investing in the Indonesian market, but several obstacles currently impede them from participating fully. First, the tax regime applied to corporate bonds discourages foreign investors. Indonesia could attract these investors by reducing or eliminating the withholding tax on bonds and the long-term capital gains tax, which are higher than in peer markets. Second, the legal framework inadequately protects foreign investors given, for example, the long time to resolve cases and low recovery rates for creditors in insolvency proceedings. Policy-makers should consider improving legal enforcement in bankruptcy cases and other business disputes. Lastly, a lack of appropriate hedging mechanisms (no forward market exists beyond six months) also impedes foreign investment. Hedging mechanisms would enable foreigners to properly mitigate the interest rate and foreign exchange risks arising from investments in the Indonesian market.

3. Market access and efficiency

A number of challenges related to market access and efficiency currently constrain the development of the Indonesian corporate bond market. Several potential opportunities include:

A. Improving coordination between regulatory bodies

Indonesia has no coordinated regulatory body, which constitutes a key barrier to accessible and efficient capital markets. Currently, different stakeholders, including the Ministry of Finance, Bank of Indonesia and Otoritas Jasa Keuangan (OJK), the financial services regulator, look at issues separately without a clear mechanism for agreeing on solutions that span across regulators. The Bank of Indonesia and OJK both have distinct task forces on financial market development, but are currently not well coordinated in their messages to the market. Efforts are under way and should continue to strive for improved coordination among these bodies. Indonesia should consider taking more of an overarching view of capital market development by bringing together all involved stakeholders and senior leadership with the ability to settle disagreements between different stakeholders.

B. Enhancing the feedback mechanism between regulators and the private sector

Market players currently believe that market participants are not sufficiently consulted on regulatory changes. Policy-makers could consider the approach taken in Singapore, where a strong, centralized and pro-market regulator is closely integrated with the stock exchange and holds regular meetings with private-sector players, enabling quick feedback and adaptation of policies and laws.

C. Developing hedging products further

Market participants cannot hedge appropriately without certain products, including derivatives, bond exchange-traded funds, asset-backed securities and real estate investment trusts. While some of these products are in place, they have not grown and are considered unsuccessful. Policy-makers should strive to launch and strengthen the development of plain vanilla products for trading and hedging.

D. Encouraging development of an electronic platform with wide participation from local foreign dealers

Bond trading is largely conducted over-the-counter by phone, though single-dealer platforms already exist, albeit with poor liquidity. The development of an electronic platform with wide participation from local foreign dealers would help with market-making and allow for better price discovery in the market.

Conclusion

The development of capital markets across the world's fastest-growing emerging economies has progressed significantly over the past few decades. Nonetheless, emerging markets still have significant room to develop their capital markets further, as they look to achieve sustained economic growth and attract more investment. Given the potential complexity of capital market development, policies must be put into place now that will allow capital markets to flourish.

As markets in any two countries will never be exactly the same, the capital markets development process will look different in each economy. At the same time, this White Paper highlights a series of challenges and lessons learned which can offer insight for any emerging economy considering its own capital markets development process. The equity market in Colombia and corporate bond market in Indonesia offer two interesting case studies: they provide examples of key issues, as well as solutions suggested by capital market stakeholders for policy-makers to consider as they navigate their own process of capital market development.

For the future, the Accelerating Capital Markets Development in Emerging Economies initiative plans to expand its scope. It looks to explore the steps that emerging-market policy-makers can take to attract global investors as a means for accelerating local capital market growth. After focusing on particular asset classes in its first year and on countries in its second year, concentrating on a specific segment of market participants is a logical transition for the initiative. As with its prior areas of focus, the goal for the next year will be not only to create stronger networks between local players, foreign investors and relevant governments, but also to build a global repository for best practices and policy actions – those that can help accelerate the development of capital markets across emerging economies worldwide.

Appendix

The World Economic Forum publishes the most comprehensive assessment of national competitiveness worldwide in its annual *Global Competitiveness Report*. The report assesses the competitiveness landscape of 140 economies, providing insight into what drives their productivity and prosperity.

The report's ranks are based on the Global Competitiveness Index (GCI) that was introduced by the Forum in 2004 and defines competitiveness as *the set of institutions, policies and factors that determine the level of productivity of an economy*. GCI scores are calculated by drawing together country-level data covering 12 categories – the pillars of competitiveness – that collectively make up a comprehensive picture of a country's competitiveness. The 12 pillars are: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication and innovation.

Colombia

In 2015-2016, Colombia gained five places overall to rank 61st (Figure A.1), largely due to an impressive improvement in financial market development, the most relevant pillar here, where Colombia rose 45 places to 25th (Figure A.2).

Figure A.1: Colombia's ranking on competitiveness

	Info	Rank / 140	Score	Trend	Distance from best
Global Competitiveness Index 1-7 (best)		61	4.3		
Subindex A: Basic requirements 1-7 (best)		77	4.5		
1st pillar: Institutions 1-7 (best)		114	3.3		
2nd pillar: Infrastructure 1-7 (best)		84	3.7		
3rd pillar: Macroeconomic environment 1-7 (best)		32	5.5		
4th pillar: Health and primary education 1-7 (best)		97	5.3		
Subindex B: Efficiency enhancers 1-7 (best)		54	4.3		
5th pillar: Higher education and training 1-7 (best)		70	4.3		
6th pillar: Goods market efficiency 1-7 (best)		108	4.0		
7th pillar: Labor market efficiency 1-7 (best)		86	4.1		
8th pillar: Financial market development 1-7 (best)		25	4.6		
9th pillar: Technological readiness 1-7 (best)		70	3.8		
10th pillar: Market size 1-7 (best)		36	4.8		
Subindex C: Innovation and sophistication factors 1-7 (best)		61	3.7		
11th pillar: Business sophistication 1-7 (best)		59	4.1		
12th pillar: Innovation 1-7 (best)		76	3.2		

Source: World Economic Forum, *The Global Competitiveness Report 2015-2016*

Figure A.2: Colombia's ranking on financial market development

	Info	Rank / 140	Score	Trend	Distance from best
8th pillar: Financial market development 1-7 (best)		25	4.6		
A. Efficiency 1-7 (best)		68	3.5		
Availability of financial services 1-7 (best)		51	4.8		
Affordability of financial services 1-7 (best)		114	3.6		
Financing through local equity market 1-7 (best)		73	3.5		
Ease of access to loans 1-7 (best)		77	2.8		
Venture capital availability 1-7 (best)		70	2.7		
B. Trustworthiness and confidence 1-7 (best)		7	5.7		
Soundness of banks 1-7 (best)		24	5.8		
Regulation of securities exchanges 1-7 (best)		58	4.4		
Legal rights index 0-10 (best)		1	12.0		

Source: World Economic Forum, *The Global Competitiveness Report 2015-2016*

Indonesia

After leapfrogging 16 places in the past two years, Indonesia posted an overall performance (37th; Figure A.3) that was almost unchanged from last year. In financial market development, the most relevant pillar here, Indonesia fell seven places from 42nd to 49th (Figure A.4).

Figure A.3: Indonesia's ranking on competitiveness

	Info	Rank / 140	Score	Trend	Distance from best
Global Competitiveness Index 1-7 (best)		37	4.5		
Subindex A: Basic requirements 1-7 (best)		49	4.8		
1st pillar: Institutions 1-7 (best)		55	4.1		
2nd pillar: Infrastructure 1-7 (best)		62	4.2		
3rd pillar: Macroeconomic environment 1-7 (best)		33	5.5		
4th pillar: Health and primary education 1-7 (best)		80	5.6		
Subindex B: Efficiency enhancers 1-7 (best)		46	4.3		
5th pillar: Higher education and training 1-7 (best)		65	4.5		
6th pillar: Goods market efficiency 1-7 (best)		55	4.4		
7th pillar: Labor market efficiency 1-7 (best)		115	3.7		
8th pillar: Financial market development 1-7 (best)		49	4.2		
9th pillar: Technological readiness 1-7 (best)		85	3.5		
10th pillar: Market size 1-7 (best)		10	5.7		
Subindex C: Innovation and sophistication factors 1-7 (best)		33	4.1		
11th pillar: Business sophistication 1-7 (best)		36	4.3		
12th pillar: Innovation 1-7 (best)		30	3.9		

Source: World Economic Forum, *The Global Competitiveness Report 2015-2016*

Figure A.4: Indonesia's ranking on financial market development

	Info	Rank / 140	Score	Trend	Distance from best
8th pillar: Financial market development 1-7 (best)		49	4.2		
A. Efficiency 1-7 (best)		28	4.3		
Availability of financial services 1-7 (best)		45	4.9		
Affordability of financial services 1-7 (best)		40	4.9		
Financing through local equity market 1-7 (best)		34	4.2		
Ease of access to loans 1-7 (best)		15	3.9		
Venture capital availability 1-7 (best)		17	3.8		
B. Trustworthiness and confidence 1-7 (best)		78	4.0		
Soundness of banks 1-7 (best)		74	4.8		
Regulation of securities exchanges 1-7 (best)		61	4.4		
Legal rights index 0-10 (best)		80	4.0		

Source: World Economic Forum, *The Global Competitiveness Report 2015-2016*

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A key theme of this initiative is that capital market development is most successful accompanied by strong government sponsorship supported by multistakeholder engagement. In this spirit, the recommendations in this White Paper have been developed through discussions with a spectrum of market participants including banks, institutional investors, asset managers, stock exchanges, financial information and data providers, policy-makers and others. This publication reflects the ideas and contributions of many individuals, via interviews, conference calls, workshops and document reviews. The project team would like to offer its special gratitude to the members of the project's steering and advisory committees, as well as other industry experts who graciously shared their time and insights during the preparation of this White Paper.

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