



# Corporate Bond Market Development in Turkey

**Istanbul Conference**

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# Content

- **Background and program**
- Importance of a well diversified financial sector
- Corporate Bond Market in Turkey
- Challenges and priorities

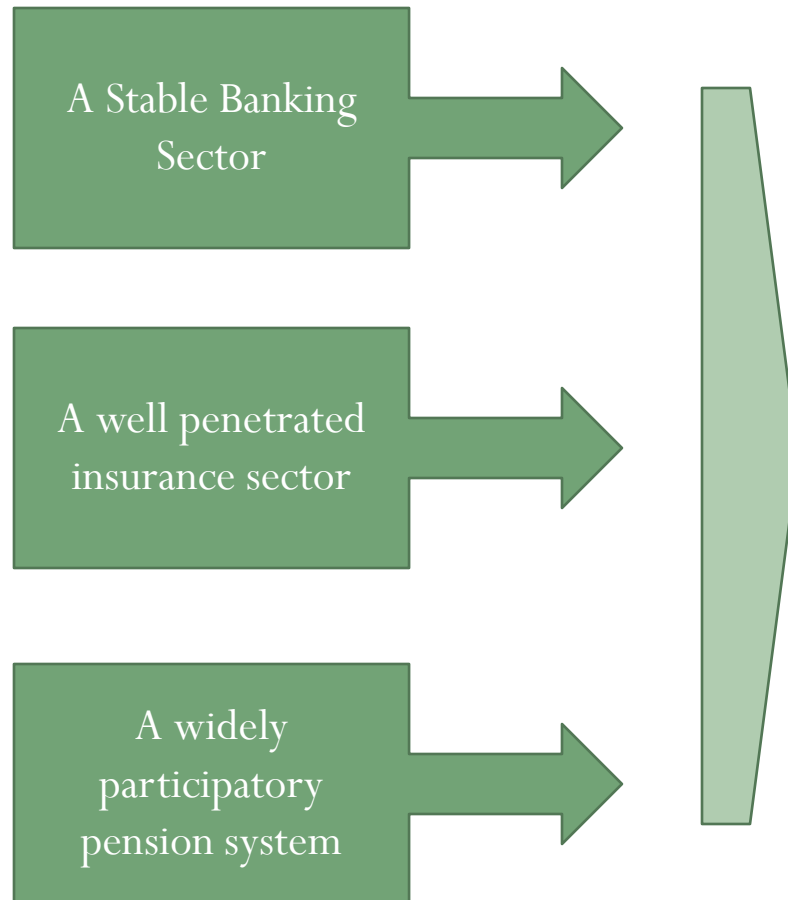


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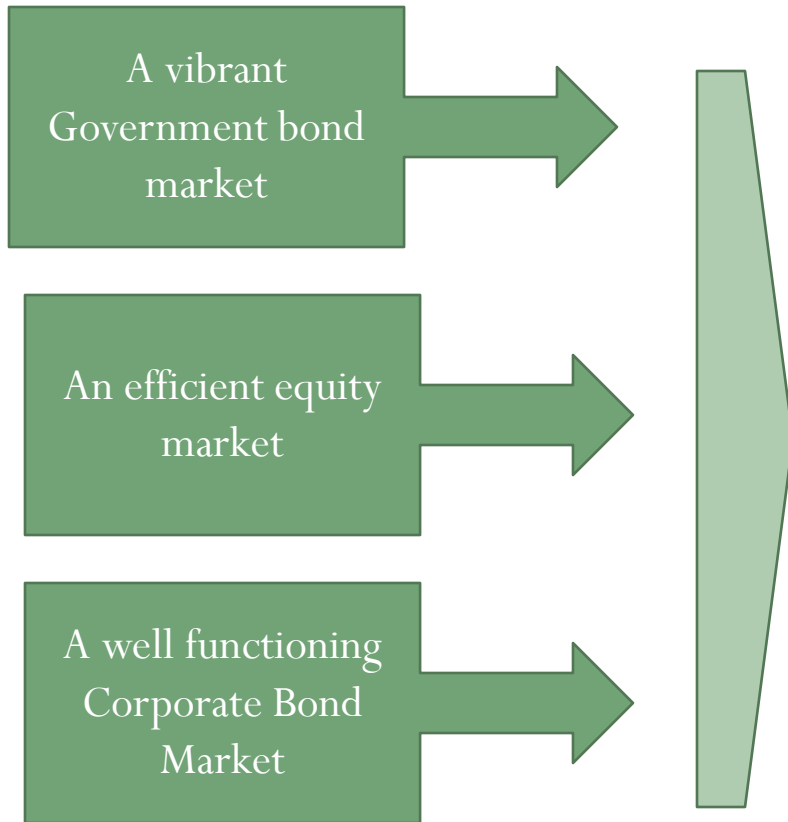
## Pillars of a Financial Sector — A diversified financial sector is more stable than one highly dependent on the banking system



- Turkey's financial market is dominated (88%) by a *strong* banking sector
- NBFIs accounted for only 12 % of the sector
- The concentration of financial intermediation in banks could expose Turkey to relatively higher systemic risks in the future.



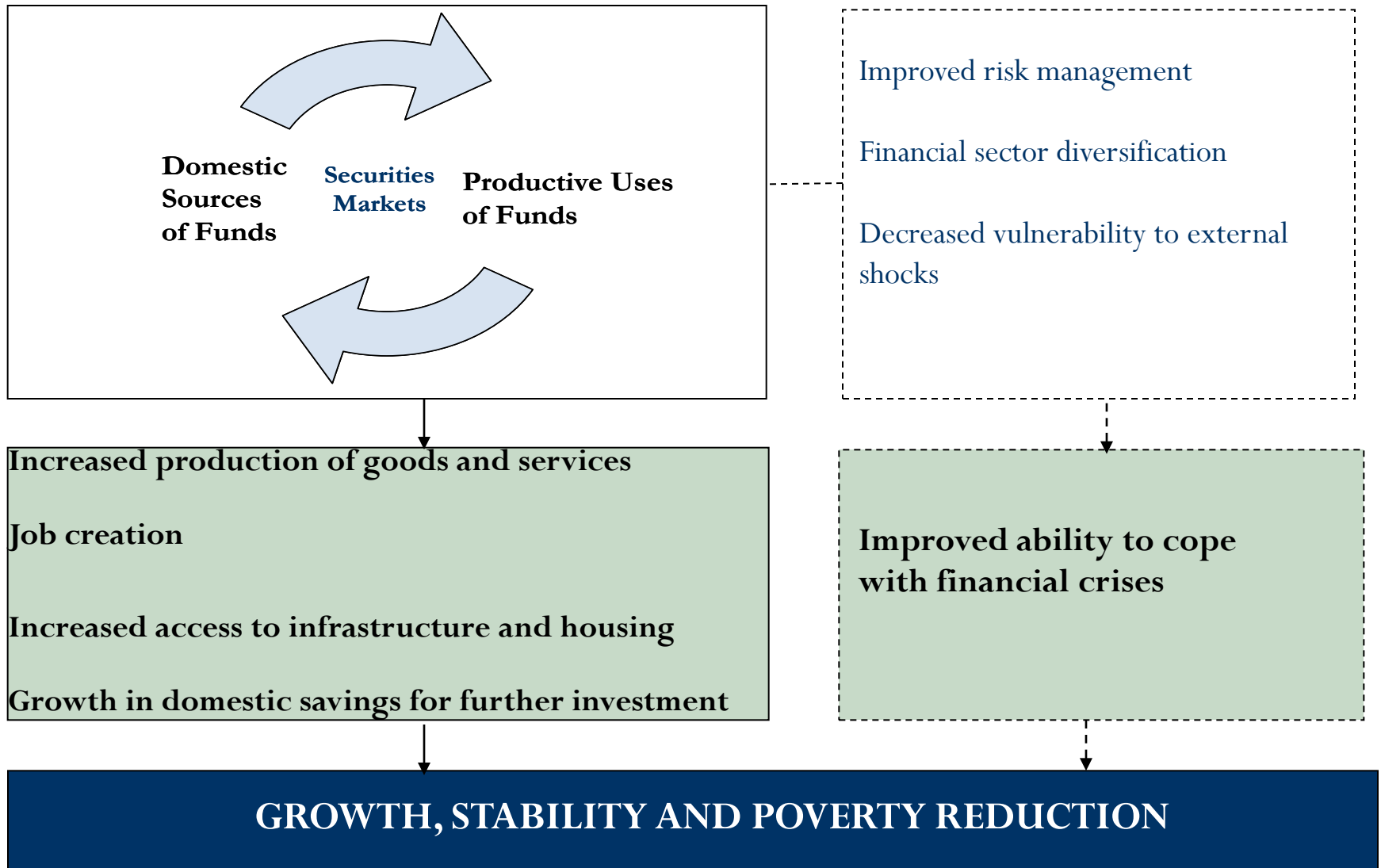
# Pillars of a Financial Sector – Banks and capital markets are complements, not substitutes.



- well-functioning government bond market.
  - Government has not just been able to reduce the overall level of debt but also materially changed composition of its debt.
- Stock Market performing well
- Corporate Bond nascent stage
  - Critical to take right steps



# Importance of Securities market for development

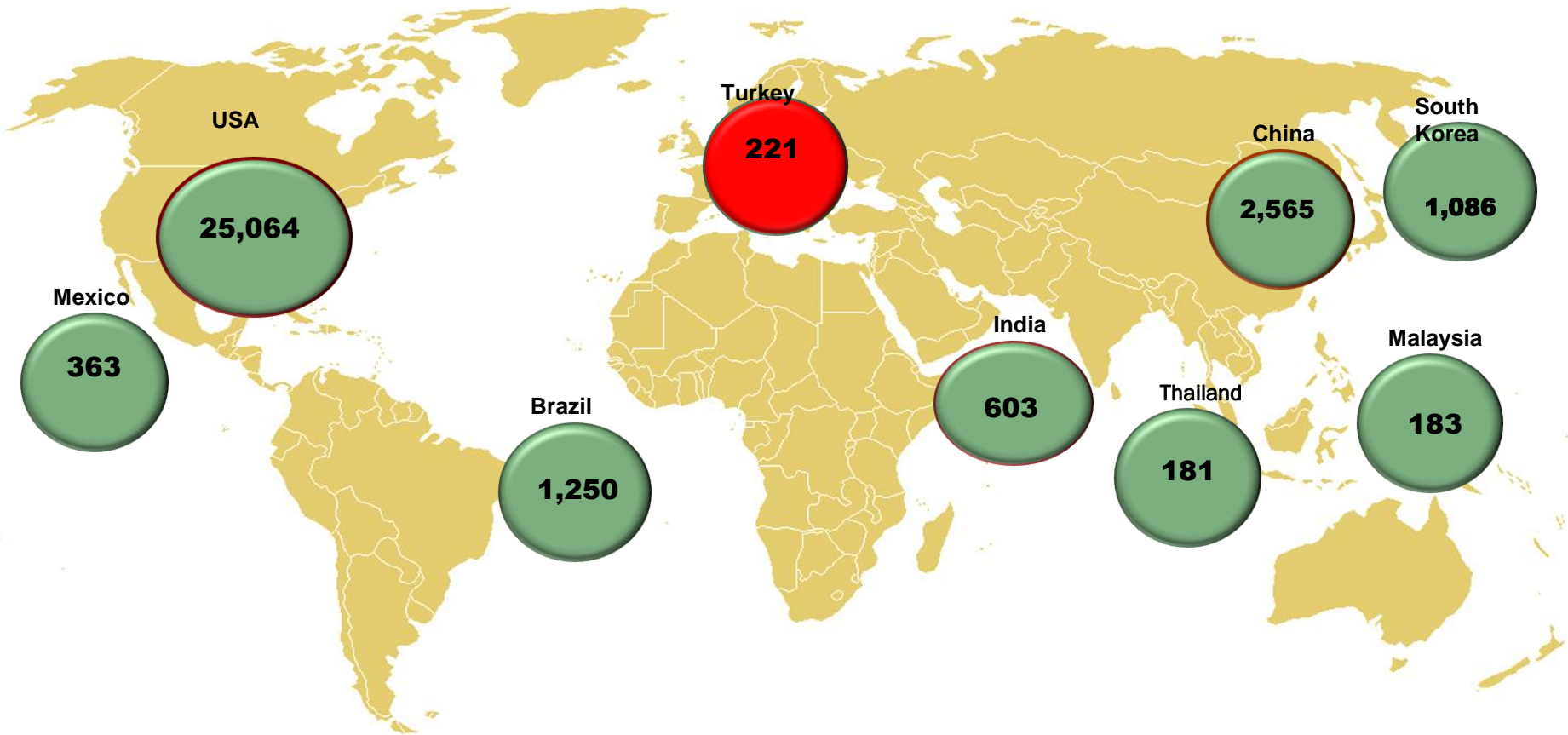


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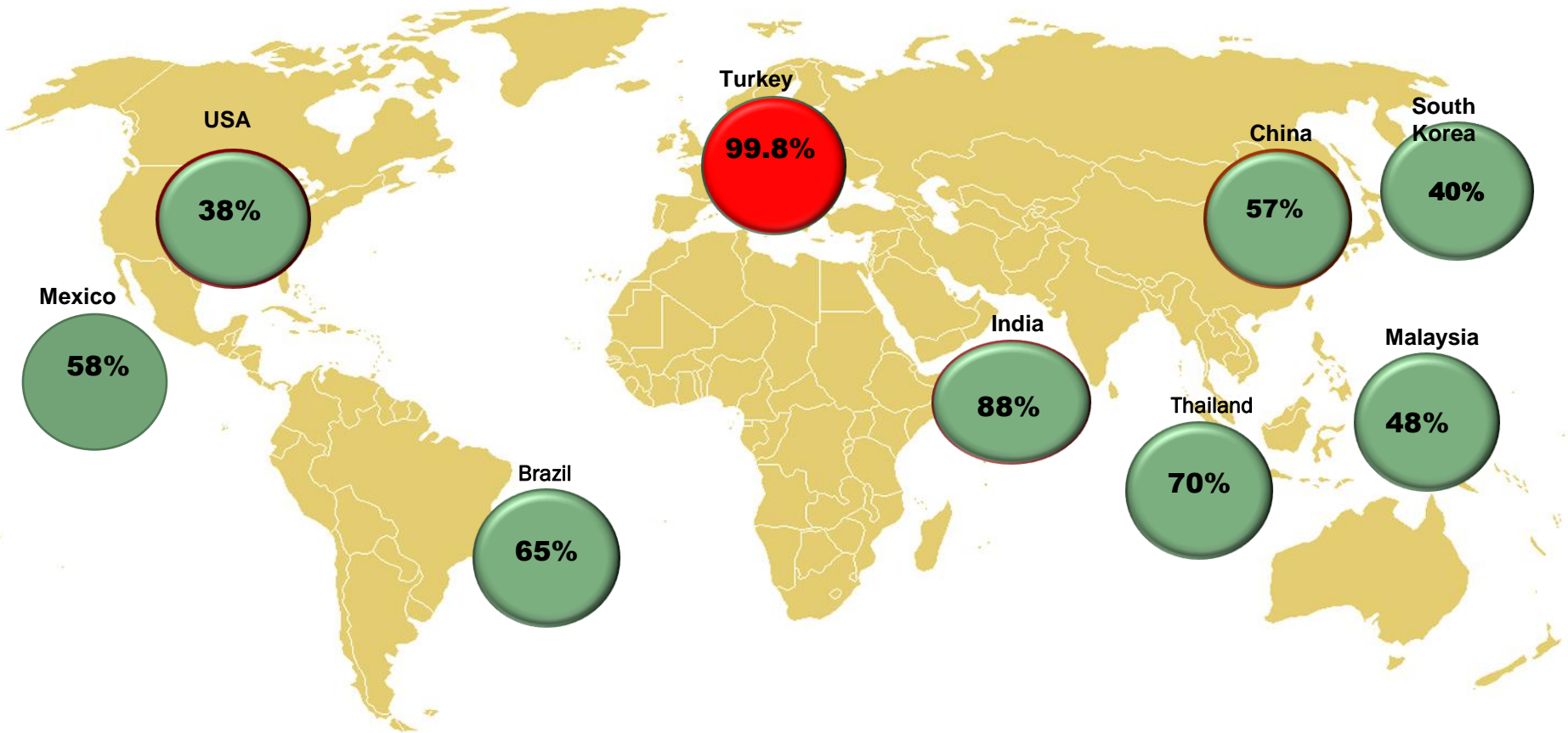
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# The Global Government and Corporate Bond Market (\$B)



# % of the market that is Government Bonds



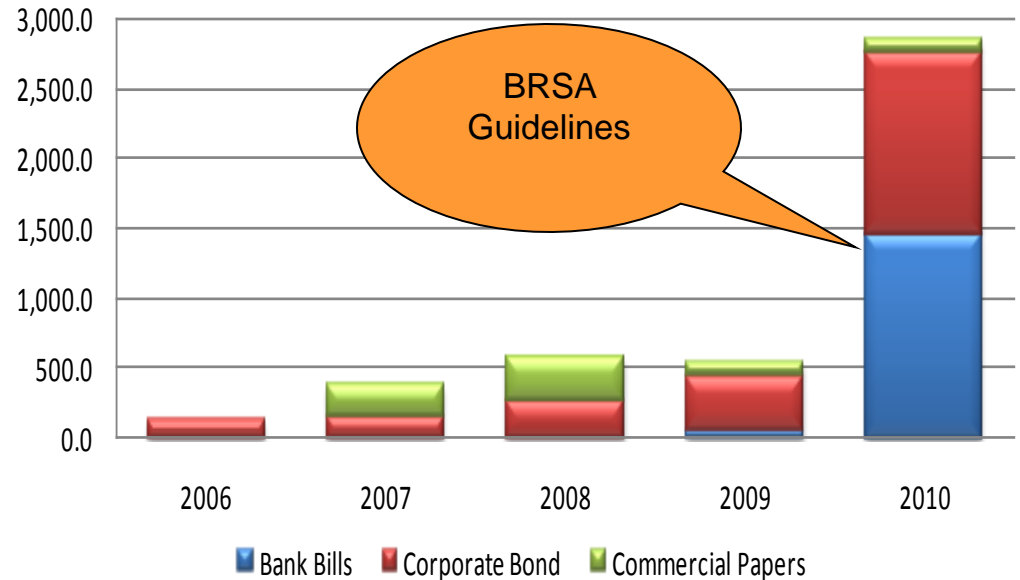
# Turkish Bond Market - Upswing

Macroeconomic and financial sector reform

Stability of TL

Decline in interest rates

## Turkey-Corporate Bond Outstandings (TL '000)



Source: Capital Market Board

Turkish banks can potentially issue up to TL51 billion in new TL debt instruments

# Non-bank Corporate Issuers

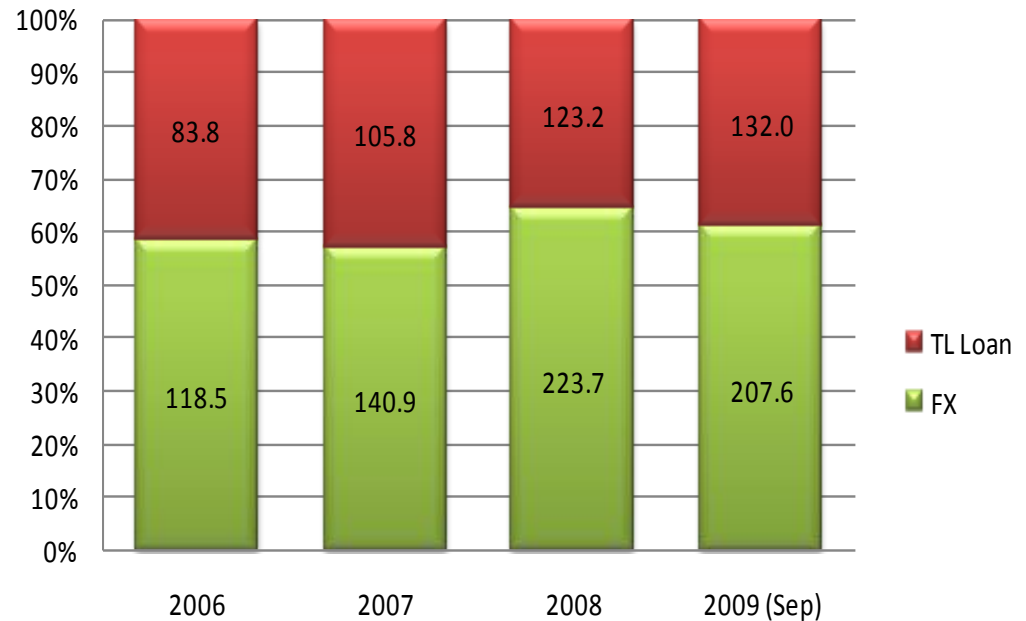
overall leverage ratio acceptable.

Interest rate risk

FX risk

Maturity risk

Composition of Corp Sector Loans  
(TL Billion)



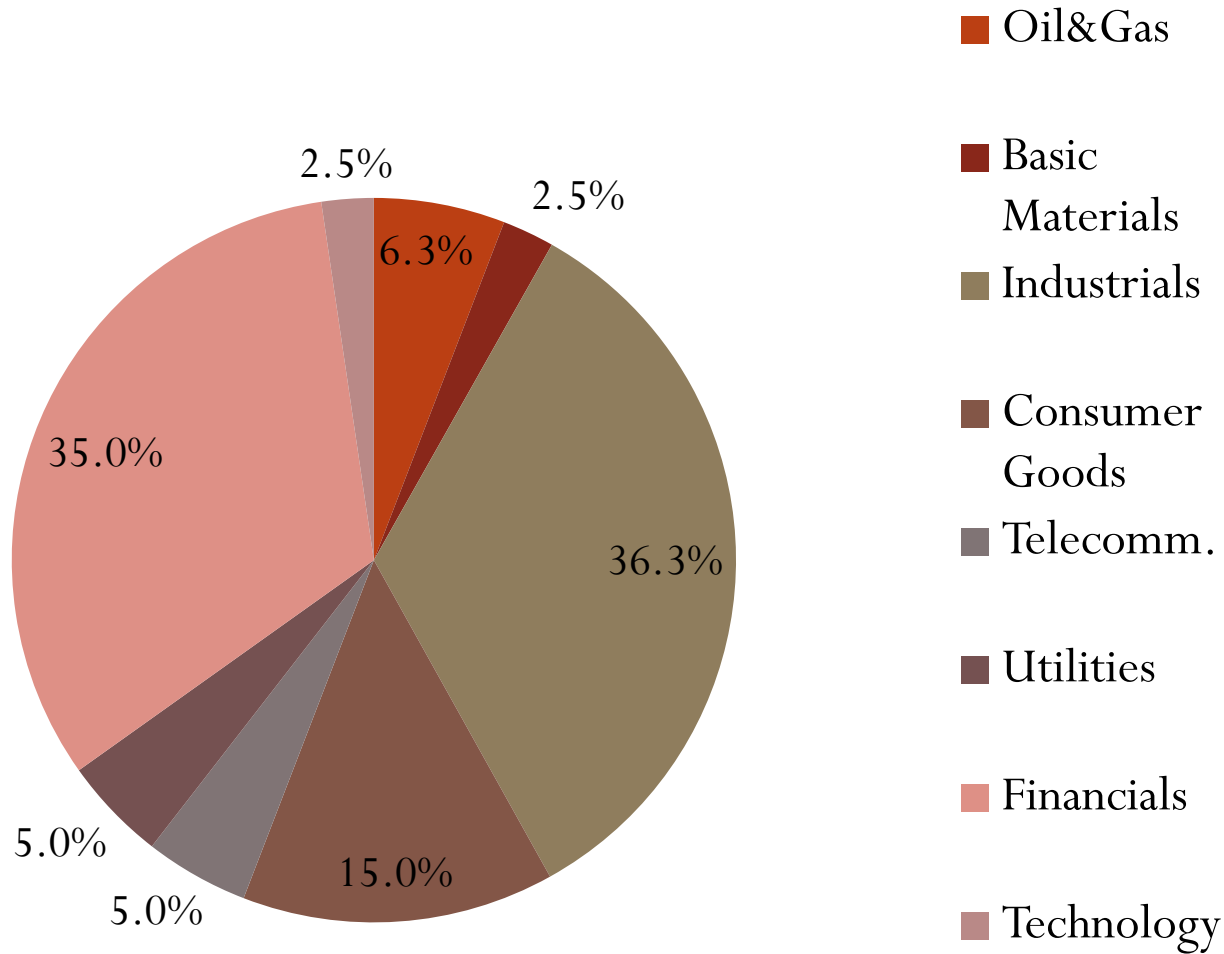
Source: BRSA-CBRT

- Potential size of Turkish corporate bond market is \$70 billion assuming that only 50% of existing foreign currency loans are refinanced in local markets

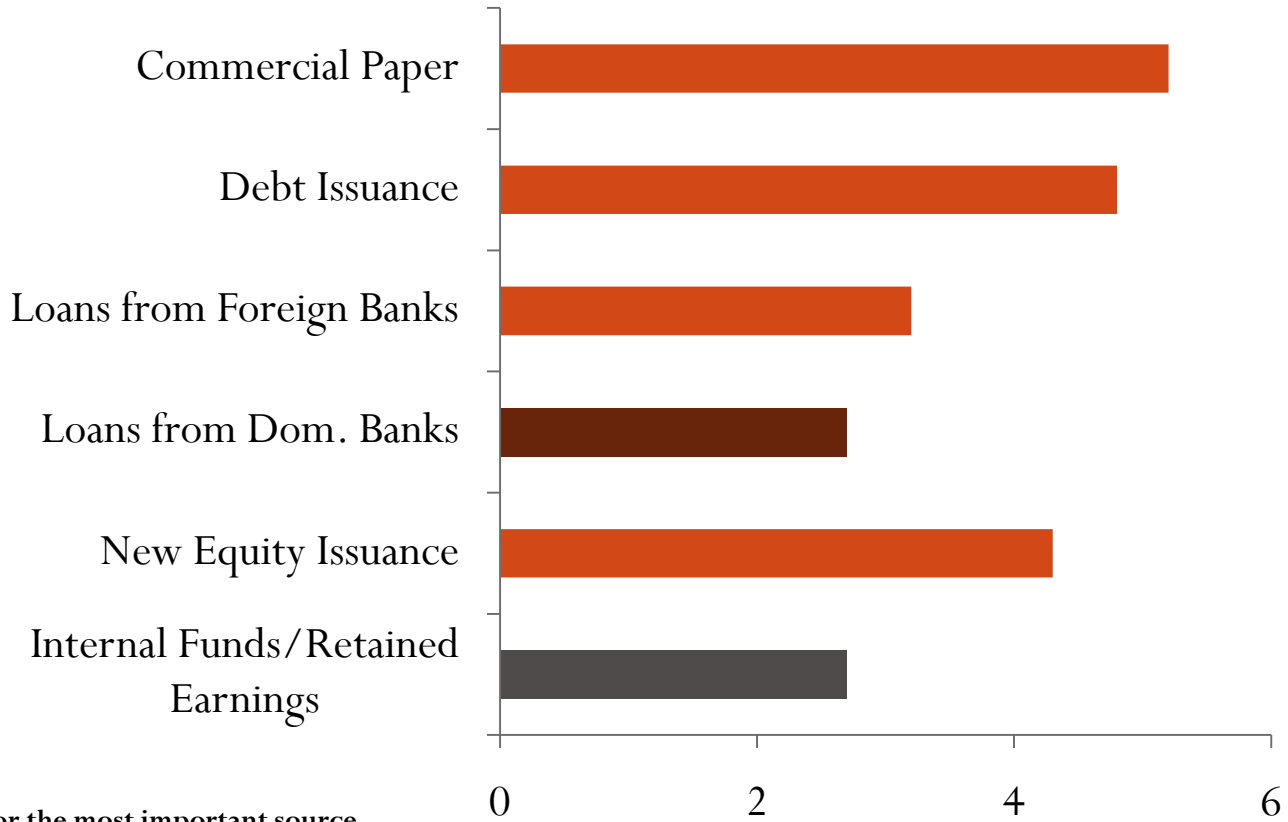
# Financing options for Corporates

- Corporate sector in Turkey is also subject to **maturity risk**
  - 30 % of loans from abroad are with a maturity of up to one-year.
    - High rollover risk
- Corporate sector exposed to **interest rate risk**
  - 70.8 % of loans received by the corporate sector were floating rate loans
  - Rising international interest rates will have major impact on profitability of the Turkish corporate sector
    - For some sectors such as SMEs, bank-based financing is preferable.
- Credit ceiling of Turkey makes accessing funds from international capital markets relatively more expensive
  - offering need to be registered also 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.
- Local currency funding would enable the corporate sector to minimize both currency and maturity mismatch
  - lessen the impact of volatile foreign capital flows.

# Industry Structure of Survey Companies



# Internal Funds and Loans from Domestic Banks are Main Sources of Corporate Financing in Turkey

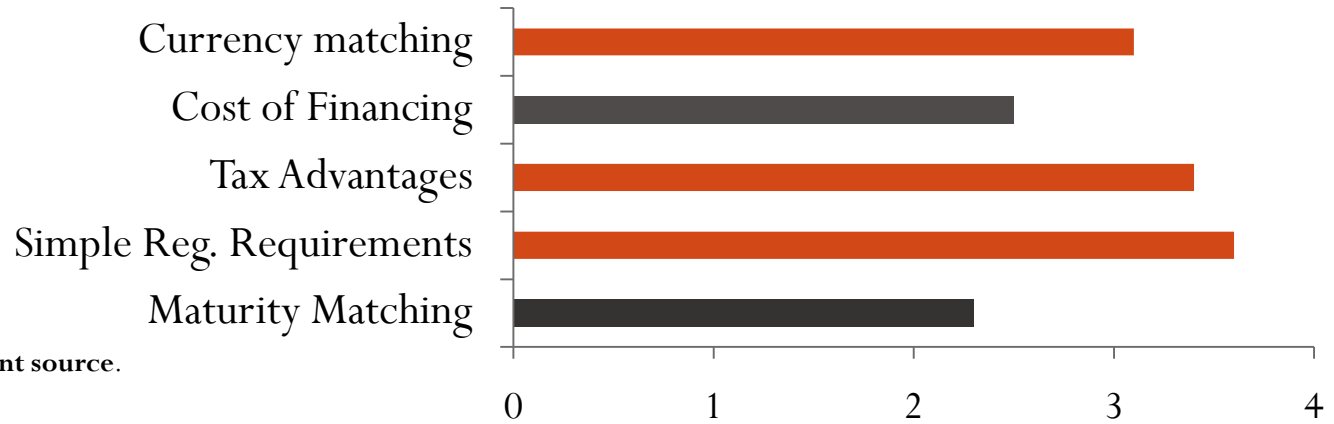


Note: 1 for the most important source.



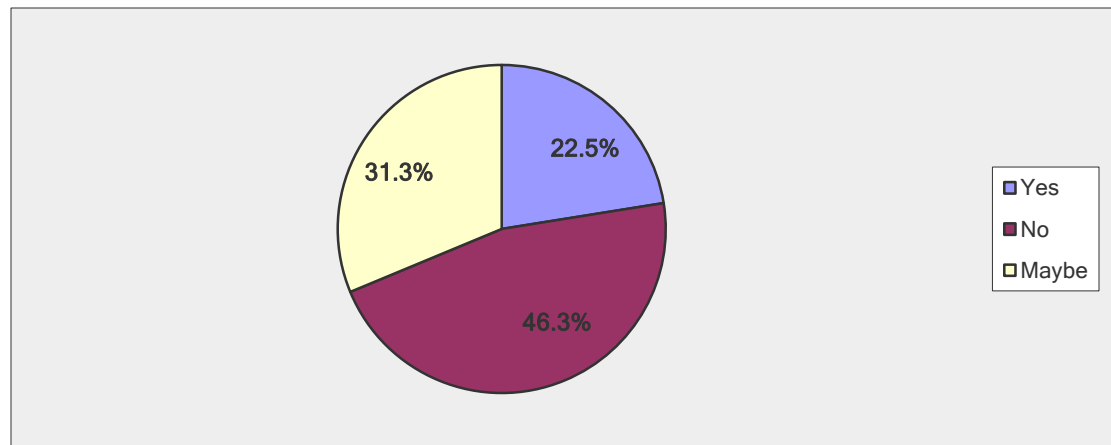
# Perception of benefits and future plans

- Firms perceive maturity mismatching and low financing costs (interest only) as main advantages of issuing bonds).



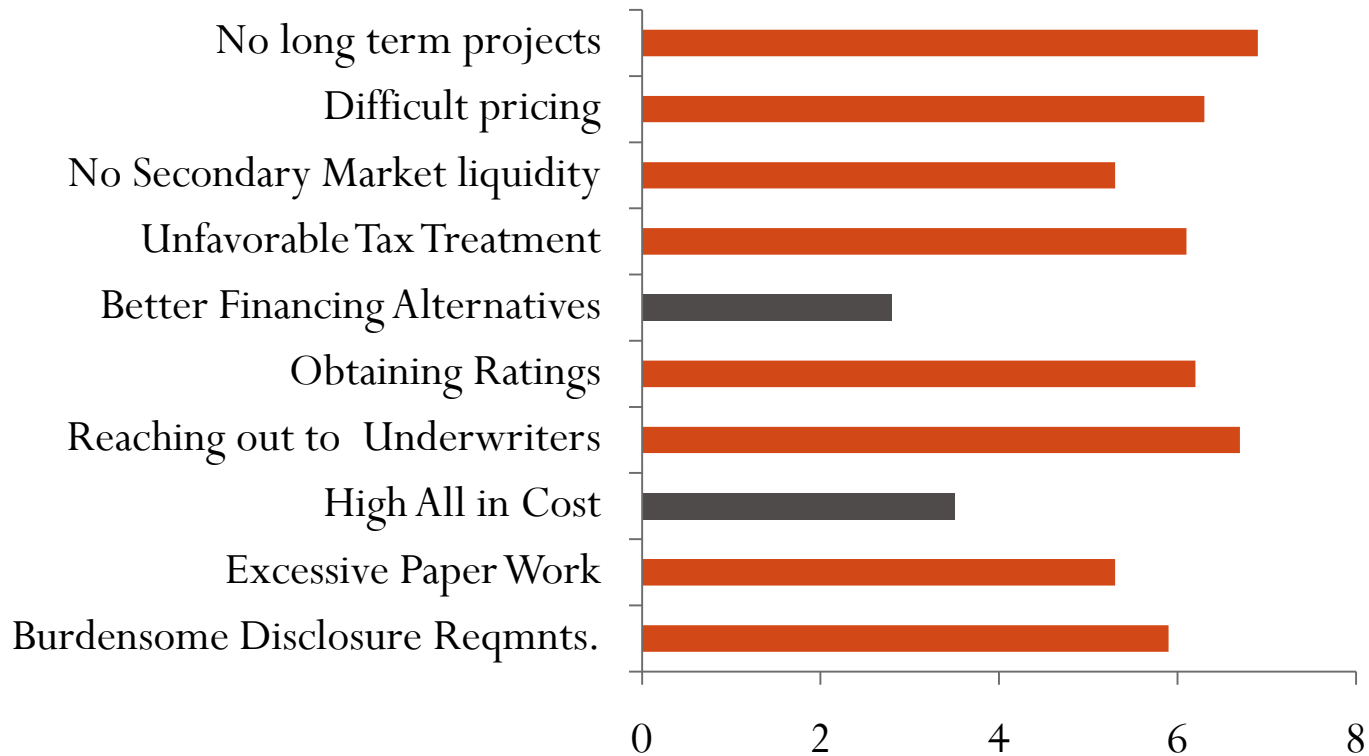
Note: 1 for the most important source.

- Almost half of surveyed companies is planning to issue bonds in the future



## Perceptions for issuance

- Main reasons companies not issue bonds are availability of better financing alternatives and high all in costs



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# Primary Market

- Past focus was on promoting issuance by SMEs.
  - SMEs do not have investment grade and risky for naive investors
  - This has been corrected and now the focus is on promoting blue chip companies (banks and non-banks) to issue bonds in domestic markets. BSRA's guidelines have greatly facilitated issuance by banks. Issuance by banks have increased sharply.
- Efforts should be made to promote blue chip corporate companies to issue bonds in domestic market
- Multinationals operating in Turkey should also be permitted to issue bonds (Malaysia has done this)
- Utility companies can also be natural issuers

# Secondary Market

- ❑ Sound policy framework essential but also supporting institutional infrastructures
  - ❑ Market based risk free benchmarks 😊
    - ❑ Currently, the risk free benchmark issue in Turkey is 22 month zero coupon bonds and, therefore, it creates a maximum maturity of private issuers.
  - ❑ Well capitalized market makers 😊
  - ❑ Liquidity 😊
    - ❑ The government bond market in Turkey one of most liquid in the world
    - ❑ Well developed system of Primary Dealers (PD).
  - ❑ Efficient clearing and settlement systems 😊
  - ❑ Credit rating agencies 😊
  - ❑ Central market information system 😊
    - ❑ Traded in the OTC market
    - ❑ Size of corporate bond is miniscule compared to the government bond market
      - ❑ No incentives for financial market intermediaries to build capacity in this area.

# Impediments facing development of corporate bond market

## Issue...

Sovereign  
Benchmark  
Yield Curves

## Needed for ...

- Essential for improving liquidity in bond markets
- Helps develop trading
- Foster development of hedging and risk management products

## Progress made...

- Government successful in lengthening maturity of its borrowings.
- Sovereign interest rate benchmark remains the 22 m zero coupon bond (54.6 % of borrowing in 2009)
- Minimal liquidity beyond 22 m.
- Average duration of TL debt < 12 m

## Next steps ...

Gradually substituting zero coupon bonds with the three-year coupon bonds

# Impediments facing development of corporate bond market

## Issue...

Lack of Investor Base (Pension/Insurance/Mutual Funds)

## Needed for ...

- growth of domestic bond market
- long-term local currency assets to meet their actuarial obligations.

## Progress made...

- Size of **domestic institutional investors** in Turkey < 7% GDP
- institutional investors in Turkey have played a limited role in supporting bond market development

## Next steps ...

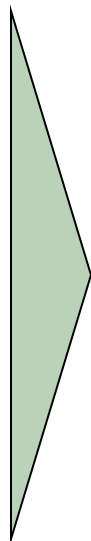
Revitalization of Pension sector and life insurance industry

# Deeper look at Investor Base

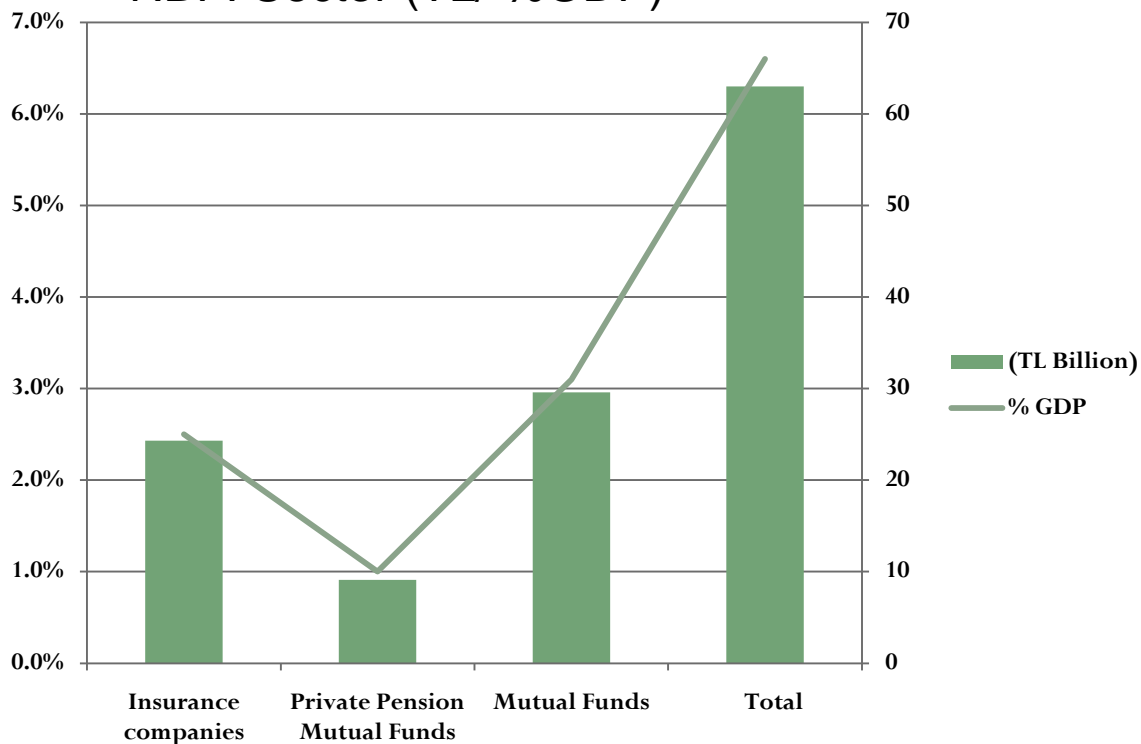
Since 2003, progress in growing investor base

TL63 B - 6.6 % GDP  
(09)

Mutual Funds  
Insurance  
Private pensions



### NBFI Sector (TL/ %GDP)

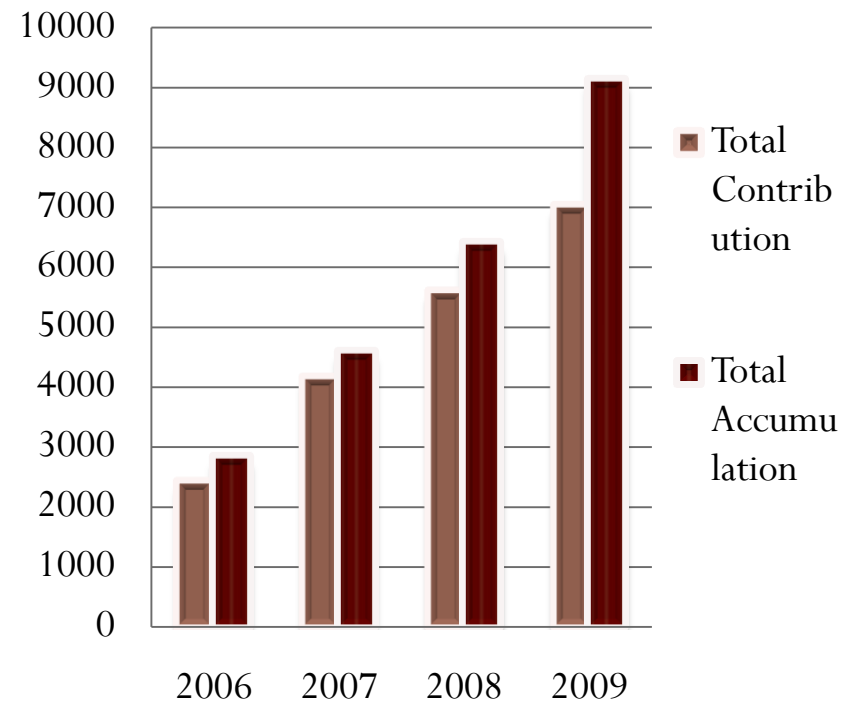


Negligible compared to comparators and a major bottleneck – For ALL aspects of development

# Deeper look at Pensions

- Private pension system law came in effect in 2003
  - diversify pension risks and increase the level of earnings directing savings
  - create a large pool of funds for job creation and help the development of the capital markets by generating long-term resources in the financial system.
- Goal increase the size to 10 % GDP by 2023
  - ambitious objective but achievable given the demographic of Turkey
- Mainly invested in TK government bonds (55 %), flexible portfolio (12.8 %), reverse repo (13 %) and equity (5%)
- Investment policies of insurance companies and pension funds should be reviewed

**Pension Growth in Turkey  
(TL Million)**



# Impediments facing development of corporate bond market

## Issue...



## Currently ...

- No market-making arrangement for corporate bonds.
- Corporate bonds **not fully accepted as collateral** for margin under the rules of ISE
- Liquidity and pricing of the corporate bonds a problem

## Steps Needed...

- CMB & ISE creating market-making system for corporate bonds as soon as possible
- PD System can be used for Corp. Bonds
- of settling trade corporate bonds on T+0 should be amended to T+2 to facilitate trading by dealers

## Time Frame ...

Relatively easy steps that can be done without major reform

# Impediments facing development of corporate bond market

## Issue...

Market infrastructure (trading/clearing/settlement)

## Currently ...

- Takasbank well functioning
- clearing and settlement bank for the ISE and TURKDEX
- National Numbering Agency
- Takasbank is regulated by both the CMB and the BSRA

## Collateral requirements

- 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

## Steps ...

Highly rated Corporate bonds be accepted as collaterals by the Takasbank

# Impediments facing development of corporate bond market

## Issue...



## Currently ...

- industry in Turkey is an early stage with mixed quality
- Local agencies need to be improved
- Encouraging local agencies to form JV with international rating agencies would be a good solution

## Mandatory Rating?

- In Malaysia, all corporate bond issues were subject to a **mandatory minimum** rating requirement of **BBB**
- instilled confidence in issuance,
- indirectly helped Malaysia's relatively new **rating agencies** (RAM and MARC)

## Steps ...

Mandatory rating be considered for public issues of corporate bonds *cost vs investor confidence (# of TK companies rated par with TK Gov)*

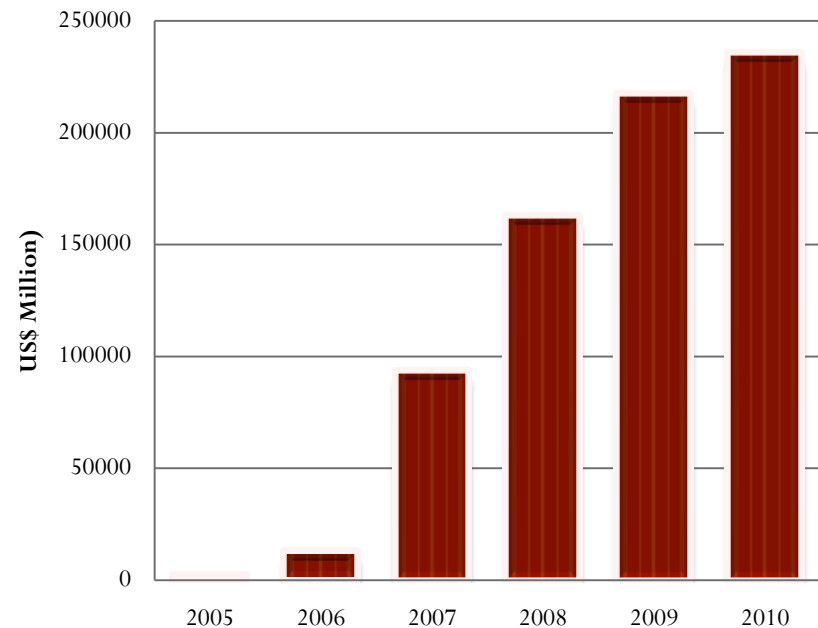
# Look at Derivates Market

- A well-developed derivative market fosters development of bond market
  - enables market participants (issuers, investors and intermediaries) to hedge against interest rate risks
- There was no formal futures market in Turkey until 2005 when the Turkey Derivative Exchange was established
- TurkDEX is one of the fastest growing exchange in the world. Its trading volume rose from US\$2.2 B in 2005 to US\$235B
- Its ranking during first half of 2010 was the number 25<sup>th</sup> in the world placing it above matured markets such as Singapore and Italian Derivative Exchange.



- Dev. Exchanges can play an important role in creating contracts such as option 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 three year Turkish Treasury coupon bond will be another possibility

**TurkDEX  
Total Trading Volume**



Source: Turdex

# Rights of Bond holders in case of insolvency weak

## Issue...

**Investor protection in case of insolvency**

## Currently ...

- According to bankruptcy law (icra iflas kanunu) **article 206**, in case of a default corporate bonds have the same ranking with ordinary receivables

## Important

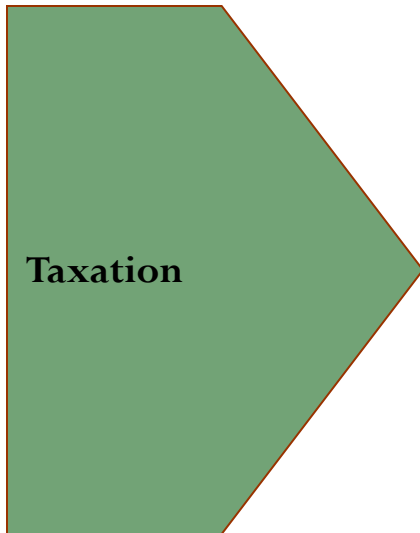
- Essential that investors of **collateralized bonds** are well protected and have creditors' rights comparable to advanced financial markets

## Steps ...

Issue is well recognized by the Turkish authorities – Act on plan to amend the regulations as a part of the **Istanbul International Financial Center (IFC-Istanbul)** project.

Taxation → comp. rate → more turnover  
= higher revenue

Issue...



Currently ...

- One of the most competitive corporate tax rates in OECD
- However, distortion in the financial markets created by taxation –should be equal treatments of all financial instruments.

Important

- Banking and Insurance Transaction Tax (BITT) Carry different tax rates between corporate and government bond
- withholding tax on bank deposits and government bonds be equalized

Steps ...

Issue is also well recognized by the Turkish authorities – Act on plan to amend the regulations as a part of the **Istanbul International Financial Center (IFC-Istanbul)** project.

# Ingredients for vibrant Bond market – Turkey - Recap

## Enabling Environment

Macro Economic Environment



Legal & Regulatory

- Issuance Process
- Market Rules



Tax Regimes



## Market Place

Trading, Clearing, Settlement, Depository



Pre-trade and post-trade transparency



Bond Market Structure



## Capacity

Bankable Projects & Sponsors



Informed / present Intermediaries



Absence of a large domestic investor base





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