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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

EL SALVADOR

CAPITAL MARKET DEVELOPMENT

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Glossary

ABS	Asset Back Securities
AFPs	Pension Fund Administrators
AFI	Organic Law of the State's Financial Administration (<i>Ley Orgánica de Administración Financiera del Estado</i>)
BCR	(<i>Banco Central de Reserva de El Salvador</i>)
BMI	(<i>Banco Multisectorial de Inversiones</i>)
BVES	(<i>Bolsa de Valores de El Salvador</i>)
CEDEVAL	Securities Deposit Central
CEFES	Provisional Investment Certificates
CIPs	(<i>Certificados de Inversión Provisional</i>)
FOP	Pensión Trust Fund (<i>Fideicomiso de Obligaciones Previsionales</i>)
DGICP	Directorate of Investment and Public Credit (<i>Dirección General de Inversión y Crédito Público</i>)
FOSALUD	(<i>El Fondo Solidario para la Salud</i>)
FOSEDU	(<i>Fideicomiso para Inversión en Educación, Paz Social y Seguridad Ciudadana</i>)
FOSEP	Salvadoran Pre-Investment Fund
GDP	Gross Domestic Product
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
LAC	Latin America and the Caribbean
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
LIBOR	London Interbank Offered Rate
NCTP	Public Treasury Credit Note
MH	Ministry of Finance (<i>Ministerio de Hacienda</i>)
NFPS	Non-Financial Public Sector
MOU	Memorandum of Understanding
RTGS	Real Time Gross Settlement System
ROSC	Report on Observance of Standards and Codes
SSF	Financial Sector Superintendence (<i>Superintendencia del Sistema Financiero</i>)
SP	Pensions Superintendence (<i>Superintendencia de Pensiones</i>)
SPP	Public Pension System (<i>Sistema de Pensiones Público</i>)
SRO	Self Regulatory Organization
SV	Securities Commission (<i>Superintendencia de Valores</i>)

I. CURRENT MARKET SITUATION¹

A. Overview

1. **The capital markets in Salvador are small and relatively underdeveloped, and have played a very limited role in the economy.** The size of capital markets in El Salvador is in line with that of neighboring markets (e.g. in Costa Rica, Guatemala and Panama), but are small, underdeveloped, and have so far played a limited role in the national economy compared with the role of relatively more advanced markets in their respective economies in the region (e.g. in Colombia, Peru and Chile) (see Table 1). At end-2009, there were only 40 listed stocks and a limited number of private corporate bond issues. Stock market capitalization was about US\$5.2 billion, equivalent to 24.6 percent of GDP. However, market capitalization plummets to 5.6 percent of GDP if we exclude the shares of financial institutions, for which listing is mandatory and that are largely controlled by foreign institutions with a minimum float in the market. The outstanding balance of public debt securities² is about US\$6 billion, which accounts for about 28.7 percent of GDP, out of which 66.7 percent is Eurobonds issued in the international markets. On average, institutional investors invest less than 10 percent of their total assets in capital market instruments. In 2009, there were only five new issuances of corporate bonds and three in the case of equity. Banks and pension funds are the main institutional investors.

2. **The current market architecture and the natural monopoly it grants to the Exchange hamper market development and prevent the modernization of the regulatory framework.** All products and players are required by regulation to be listed on a domestic Exchange. The only existing Exchange (Bolsa de Valores de El Salvador, BVES), benefits from a natural monopoly as a result of both the small market size and the current regulatory framework that restricts non-exchange entities to provide alternative electronic trading facilities and allows a direct control of the only central depository in the country, CEDEVAL, by the BVES. All of which limits the possibilities of competition in the short- to medium-term. That framework has not only created unnecessary costs to different types of transactions where the BVES adds little value (e.g. requiring that buying and selling of foreign securities between brokers and their clients has to be done exclusively through the Exchange), but it also reduces the possibility of providing alternative avenues of access to the capital markets for potential issuers, which could tap the institutional segment of the market, where the assumptions of protection and liquidity are very different from those of the retail market. For that reason, no alternative is available to public offers (to be listed), nor is over-the-counter (OTC) trading allowed in the fixed income market.

¹ This technical note was prepared by Clemente Luis Del Valle and Yibin Mu (both World Bank, GCMSM).

² The public debt includes the Pension Trust Fund (*Fideicomiso de Obligaciones Previsionales*, FOP) and the Investment in Education, Social Peace and Citizen's Security Trust Fund (*Fideicomiso para Inversion en Education, Paz Social y Seguridad Ciudadana*, FOSEDU) because they involve issuance of securities which have a claim on government revenues: the government makes annual budget transfers to cover interest and principal payments of the securities issued by the trust funds.

Table 1. El Salvador Market in Comparison with Peers

	Source	Year	El Salvador 1/	Regional Median	Income Group Median	Costa Rica	Guatemala	Honduras	Nicaragua	Panama	Chile	Colombia	Peru
CAPITAL MARKET													
Number of Listed Companies	S&P	2008	41	55	244	11	-	-	-	31	235	96	199
Stock Market Capitalization / GDP (%)	S&P	2008	24.40	26.74	20.13	6.33	-	-	-	28.45	78.15	35.92	43.65
Gross Portfolio Equity Assets / GDP (%)	IFS	2008	1.22	0.28	0.09	0.23	-	0.12	-	0.28	19.93	-	7.06
Outstanding Domestic Private Debt Securities / GDP (%)	BIS	2008	4.76	3.59	3.21	-	-	-	-	-	15.02	0.32	3.59
Outstanding Domestic Public Debt Securities / GDP (%)	BIS	2008	25.40	16.58	31.05	-	-	-	-	-	9.09	20.65	11.45
Outstanding International Private Debt Securities / GDP (%)	BIS	2008	1.65	2.14	1.65	0.34	0.35	-	-	5.52	4.68	1.40	2.08
Outstanding International Public Debt Securities / GDP (%)	BIS	2008	14.65	7.57	2.45	5.20	2.45	-	-	33.53	1.33	6.26	6.29
Gross Portfolio Debt Assets / GDP (%)	IFS	2008	19.24	2.99	1.12	2.99	0.55	1.74	-	32.69	15.05	6.58	1.03
Gross Portfolio Debt Liabilities / GDP (%)	IFS	2008	86.22	6.21	1.97	3.11	2.56	-	-	29.22	6.88	6.21	6.20
INSTITUTIONAL INVESTORS													
Insurance Premiums (Life) / GDP (%)	AXC O	2008	0.66	0.66	0.23	0.28	0.22	0.51	0.28	0.97	2.46	0.96	0.45
Insurance Premiums (Non-Life) / GDP (%)	AXC O	2008	1.08	1.30	0.77	1.87	0.78	1.15	1.26	1.84	1.30	1.04	0.58
Insurance Company Assets / GDP (%)	NBFI	2007	2.20	3.05	2.88	1.82	1.40	2.88	0.46	-	17.91	4.56	3.21
Mutual Fund Assets / GDP (%)	NBFI	2007	2.60	4.77	10.03	4.77	-	-	-	-	8.59	-	-
Pension Fund Assets / GDP (%)	NBFI	2007	19.40	16.28	3.30	8.86	-	-	-	5.21	64.42	16.28	17.96

1/ Most of the data for El Salvador were provided by the BCR and SV.

Table 2. Overview of Local Capital Market in El Salvador

	2005	2006	2007	2008	2009
Public debt securities (US\$ Million)	4,478.2	5377.1	5057.7	6,030.7	6,495.0
of which Eurobonds	3,440.0	3,290.0	3,240.0	3,240.0	4,040.0
of which FOSEDU			60	30	
of which CIPs		992.5	436.1	420.5	443.3
Government securities (% of GDP)	26.0	23.6	22.7	25.4	28.7
Corporate bonds					
Outstanding Volume (US\$ Million)	909.6	823.0	1,021.8	1,052.8	1,137.4
Number of Outstanding Issues	41	40	38	44	40
Number of New Issues	10	6	3	8	5
Equity Markets					
Number of Listed Companies	39	39	42	41	40
Number of New Listings	4	1	3	0	3
Market Capitalization (US\$ m)	3,683.0	5,352.0	6,048.0	5,398.0	5,195.0
of which financial institutions(US \$m)	2,600.9	3,832.6	4,340.1	4,264.9	4,204.8
Market Capitalization (% of GDP)	21.4	28.5	29.7	24.4	24.6

Source: BCR and SV.

Table 3. Main Secondary Market Activities Indicators (Repo Markets)

	2005	2006	2007	2008	2009
Total Repo Transactions	5,549.0	5,022.7	3,940.7	3,404.0	1,266.6
Repo Transactions of Public Instruments	5,077.6	4,290.7	3,179.9	2,874.5	974.4
Total Number of Operations	22,231	18,923	16,366	14,081	6,236
Days of Operation	250	251	249	250	247
Average Daily Amount (US\$ Million)	22.2	20.0	15.8	13.6	5.1

Source: BVES.

B. Market Intermediaries

3. **Brokerage firms are the main market intermediaries.** The number of brokerage houses has reduced from 23 in 2000 to 12 in December 2009, following liberalization of the industry. Out of the 12 brokerage houses, 10 are part of financial conglomerates. The brokers have historically been performing traditional brokerage and fund management activities; however, the latter has been practically phased out by the bank-controlled brokers (see paragraph 10). They also provide portfolio management services to their clients. Brokerages are the only direct participants of the Banco Central de Reserva de El Salvador's (BCR's) securities auctions. Proprietary positions are minimal.

C. Market Infrastructure

4. **The current clearing and settlement infrastructure has been built around BVES.** BVES is currently the only trading platform for secondary market transactions. BVES is a demutualized corporation, itself listed on the stock exchange. Central de Depósito de Valores S.A. (CEDEVAL) is the centralized securities depository mandated for all securities traded on BVES. This centralized depository offers safekeeping, transfers, and clearing and settlement of securities through a book-entry system. CEDEVAL has also conducted global operations through the Bank of New York, State Street and Clear Stream Banking utilities. The electronic settlement cycle is standardized to T+0 for repurchase agreements, T+2 for treasury bills, and T+3 for government bonds.

5. **There are several rating agencies, and a weak price discovery environment.** The Securities Commission (*Superintendencia de Valores, SV*) is in charge of licensing rating agencies, and its requirements to set up a rating agency seem very light. There are two major rating agencies in the country, including Fitch that given the very limited activity on the bond markets side, have not yet presented any major problem. Foreign ratings are not recognized for the purpose of authorizing the local listing of foreign securities. The price discovery process is very weak in this market as there are no efficient and centralizes sources of prices, and although the regulator has created conditions for private vendors to operate, there are currently no operator offering services in the local market. The development of a pricing methodology for the valuation of securities is a pending issue that will become critical when *carteras de inversión*, which are collective investment vehicles, are phased out and mutual funds become operational.

6. **Not all securities are dematerialized and the linkage between the Real Time Gross Settlement (RTGS) Systems, which was recently introduced, and the securities settlement system has not yet been fully achieved.** Dematerialization is compulsory only for the private fixed-income market while the public debt securities and equity markets are excluded. It is our understanding that equity markets were excluded from the law of “anotaciones en cuenta” (book entry) because of resistance from the banks, who were opposed to the law’s mandatory listing requirements on the BVES. The public debt securities settlement system has not been directly linked to the RTGS system. Therefore, full-fledged Delivery versus Payment (DVP) has not yet been achieved.³

D. Investor Base

7. **Pension funds constitute the largest domestic institutional investors in El Salvador, but are severely constrained in their operation. Since the privatization of the social security system in 1996, pension funds have become increasingly important in the financial system.** As of end-2009, pension fund assets were US\$5 billion, about 23 percent of GDP. There are only two pension fund administrators (AFPs) operating in the country

³ Please see Technical Note on Payments, Remittances and Securities Settlement Systems for details.

and they dominate the institutional investors segment of the financial sector. About 80 percent of pension fund assets are invested in public debt securities (Table 3) mainly due to two reasons: (i) a requirement to invest a minimum of 30 percent of assets in paper issued by the Fideicomiso de Obligaciones Provisionales (Certificados de Inversión Provisional - CIPs) to fund the pensions of workers retiring under the old pay-as-you-go system and (ii) a lack of investable domestic securities. Pension funds are required to complete all their transactions on the BVES and through brokerage firms. This adds an additional layer of fees and restricts, in particular, the development of other sectors of the securities markets such as private debt markets. For example, pension funds can only participate indirectly in the auctions of public debt securities via brokerage firms. They cannot invest in any foreign securities or exchange-traded-funds that are not listed on the BVES.

8. **Banks are important investors of public debt markets due to several prudential requirements.** As of December 2009, liquidity requirements on domestic banks were 26 percent of deposits, at least 50 percent of which has to be public debt securities. The total amount of the banking assets is US\$ 13 billion (about 61.8 percent of GDP), of which 12.4 percent are invested in public debt securities.

9. **Insurance companies are still very small investors in the capital market.** As of end-2009, total insurance fund assets were US\$556 million, about 2.7 percent of GDP. About 52 percent of insurance funds are in deposits and 38 percent in public debt securities. Insurance companies indicated that investing in bank deposits provided regulatory advantages, as they have to constitute reserves on securities investments.

10. **Collective investment schemes do not have a proper regulatory framework and the mutual fund industry still is in their infancy.** Mutual funds are not allowed under current law, but there are other collective investment vehicles – *Carteras de Inversión* — however, a relatively unregulated vehicle. These vehicles are managed by brokerage firms that issue quasi-deposit liabilities backed by long-term fixed income assets, mostly domestic government bonds. The risks of these deposits are poorly disclosed and/or understood, and they had been commercialized by the fund managers as if they were sight bank deposits, redeemable on demand. The investment funds are not marked-to-market, even if the underlying investments are liquid. However, these funds were practically phased out by the bank-controlled brokers as of 2009 at the sign of government intervention to avoid the systemic risks that arose from inadequate regulation. As the result of this phase out, the total assets decreased from US\$700 million 3-years ago to only US\$119 million, about 0.6 percent of GDP, at end of 2009. Only one remaining fund is independently owned, and accounts for 66.4 percent of the current industry's assets.

Table 4. Assets of Banks and Institutional Investors

	2005	2006	2007	2008	2009
Bank Assets (US\$ million)	11,085.09	11,762.38	13,058.24	13,479.70	13,049.00
Bank Assets (% of GDP)	64.4	62.6	64.1	60.9	61.8
Bank's Asset Composition (% of total assets)					
Deposits	2.0	1.3	1.9	1.7	4.0
Government Securities	12.0	10.2	10.5	9.7	12.3
Corporate Bonds	2.2	1.6	1.4	1.2	1.4
Loan	63.2	67.4	66.6	66.3	63.5
Equity	0.0	0.0	0.0	0.0	0.0
Foreign Debt Instruments	4.0	3.2	2.2	3.5	0.6
Other	16.6	16.2	17.5	17.6	18.2
Pension Fund Assets (US\$ million)	2,902.10	3,352.11	3,958.17	4,470.75	5,014.51
Pension fund Assets (% of GDP)	16.9	17.9	19.4	20.2	23.7
Pension Fund's Asset Composition (% of total assets)					
Deposits	13.3	16.2	17.1	18.2	17.5
Government Securities	80.3	77.8	77.8	77.3	78.7
Corporate Bonds	0.3	0.3	0.7	0.8	0.6
Equity	0.0	0.0	0.0	0.0	0.0
Foreign Debt Instruments	6.0	5.6	4.3	3.6	3.2
Collective Investment Schemes Assets (US\$ million)	682.7	527.2	538.0	340.5	119.0
Collective Investment Schemes Assets (% of GDP)	4.0	2.8	2.6	1.5	0.6
Collective Investment Scheme's' Asset Composition (% of total assets)					
Deposits	19.6	27.7	28.9	25.2	38.6
Government Securities	35.3	22.7	18.4	25.5	44.4
Corporate Bonds	28.5	31.6	34.5	38.5	17.0
Equity	0.0	0.0	0.0	0.0	0.0
Foreign Debt Instruments	16.6	18.0	18.2	10.8	0.0
Insurance Companies Assets (US\$ million)	n/d	381.2	443.2	520.2	566.9
Insurance Companies Assets (% of GDP)		2.0	2.2	2.4	2.7
Insurance Companies' Asset Composition (% of total assets)					
Deposits	48.9	51.3	51.4	53.6	52.0
Government Securities	32.7	30.7	31.6	34.6	37.9
Corporate Bonds	10.3	11.1	10.4	7.0	4.4
Equity	0.2	0.3	0.1	0.2	0.2
Foreign Debt Instruments	7.9	6.5	6.3	4.7	5.4

Source: SV.

E. Public Debt Market

11. **The main public debt issuers are the Central Government and the Central Bank (*Banco Central de Reserva, BCR*), who mainly issue short-term securities.** The Central Government issues directly through the Ministry of Finance (*Ministerio de Hacienda, MH*) and indirectly through the Banco Multisectorial de Inversiones (*BMI*)⁴. MH, BMI and BCR issue several types of instruments including bills and bonds (Table 4). Among all the instruments, only MH bonds are fixed-term. All other bonds are floating-rate bonds, and thus have no impact on extending the yield curve. As of end 2009, the outstanding of government securities is US\$ 6.5billion, about 28.7 percent of GDP.

12. **There appears to be a lack of coordination between the Central Bank and the Ministry of Finance in the development of the public securities market.** There are some overlaps in terms of maturities of government securities and central bank securities. For example, both MH and BCR issue 12-month bills. The Government uses multiple-price auctions which directly open to various investors to issue its securities while the BCR uses uniform-price auctions only directly open to brokerage firms. The market lacks precise information about the issuing plan for the upcoming three-months. This lack of coordination leads to market fragmentation which impedes the local debt market development.

13. **The current legal framework for public debt management constraints market development.** The main law regulating public debt management is the Organic Law of the State's Financial Administration (*Ley Orgánica de Administración Financiera del Estado, AFI*) of 1995, and its corresponding ordinance. However, Article 148 of the Constitution establishes that the government requires the National Assembly's authorization to carry out each domestic and external debt transaction with a maturity of over 1-year and to extend guarantees to the rest of the non-financial public sector. The Assembly first provides an initial authorization for the government to analyze each individual debt contract. The Assembly, subsequently, must ratify the contractual agreement for it to become valid. These legal restrictions have achieved its purpose to control overall public sector indebtedness. However, this process is inefficient and not conducive to managing debt strategically in terms of the aggregate portfolio, taking into account cost-risk trade-offs macroeconomic constraints, and domestic debt market constraints.

14. **Also, the AFI law does not mention [the] standard objectives for public debt management.** There is no mention of domestic debt market development as an objective. It does not state the need for a public debt management strategy nor does it state the established procedures and responsibilities for designing and approving such a strategy. Also, it establishes that short-term securities issued by the government within the budget year are not to be classified as debt. However, when such securities are issued for the purpose of establishing a yield curve and developing the money and debt markets, they have to be classified as debt.

⁴ The two trust funds (FOP and FOSEDU) are managed by BMI.

15. **Debt management responsibilities and functions are weak and dispersed among a number of institutions and units.** The MH has three separate units involved in debt management, namely, (a) the Directorate of Investment and Public Credit (*Dirección General de Inversión y Crédito Público*, DGICP), (b) the Directorate of Economic and Fiscal Policy (DEFP) and (c) the Treasury. An organizational fragmentation of this type can present difficulties for the design and implementation of a comprehensive debt management strategy. Recently, a strategic, analytical unit (the middle office) was created in DGICP, but it continues to share analytical functions with the Directorate of Economic and Fiscal Policy, which until recently was considered the middle office of public debt management. Moreover, the middle office requires a strengthening of the staff's analytical know-how. In turn, the Treasury is in charge of T-bill issuance (LETES) with the operational components of the auctions delegated to the BCR. Finally, the Finance Minister and Vice-Minister participate directly in front office activities of important funding transactions, such as Eurobonds, as a reflection of the lack of technical know-how in DGICP for front office functions related to the international markets.

16. **There is a mismatch between BCR and MH in terms of having the interest and capacity to develop the domestic debt market.** As El Salvador is a formally dollarized economy, the Central Bank does not have conventional monetary policy functions. Consequently, the BCR, which can hire and retain high-quality staff, does not have the same level of interest in developing a medium -to long- term yield curve as other central banks. The MH has keen interest in developing domestic debt market but lacks the capacity.

Table 5. Characteristics of the Public Sector Instruments Issued, Domestic Market

Instrument	Issuer	Term	Coupon	Purpose
LETES	MH	3, 6, 9, and 12 months	Zero	Temporary cash needs of Treasury
CENELI	BCR	In 2008 only 12 months	Zero	Liquidity management; weekly auction
BCR Bond	BCR	Max. 5 years	Libor + spread	
MH Bond	MH	3, 5, 7, 10 years	Fixed	Government financing
CEFES	BMI	5-year (bullet) bonds	Libor + spread	Education and security program
CIPS	BMI	25-year bonds (amortizing)	Libor + spread	Pensions

Source: World Bank, El Salvador, Public Expenditure Review 2010

F. Corporate Bond Market

17. **Few companies in El Salvador issue corporate bonds, and the market is illiquid.** As of end-2009, there were only 40 outstanding corporate bond issues. The secondary market for corporate bonds is very limited, with a 0.09 turnover ratio in 2009 according to SV. Reasons for limited secondary market include: (i) corporate bonds are normally privately placed to the shareholders of the issuing company prior to listing, and the shareholders generally follow buy-and-hold investment strategies; (ii) the requirement that pension funds hold at least 30 percent of their portfolio in CIP bonds also restricts liquidity in the bond market; and (iii) the anticipation of a change in the legal framework to introduce mutual funds, and a perceived requirement that all *carteras de inversión* will have to be liquidated before the transformation, has led to a decline in demand for bond instruments. There were only three, eight, and five new issues in 2007, 2008, and 2009 respectively (Table 1).

18. **One key impediment for corporate bond market development is a lack of a benchmark sovereign yield curve as a price reference.** As a result, the market currently uses bank's reported deposit rates as a pricing reference. This is an inadequate benchmark, as it is not market sensitive and is manipulated by the larger banks. This is also the reason why the banks' borrowing costs are often below the yield on comparable maturity public debt. The reference rate relies on deposit rates reported by banks instead of effective deposit rates from bank's balance sheet statements which make it vulnerable to manipulation by the larger banks.

19. **Other private debt instruments such as asset-backed securities (ABS) and covered bonds are yet to develop. In 2009, a law was passed that provided a securitization framework, under which companies would be licensed to be the vehicles for securitizations.** A securitization company has been established that is currently working on two transactions involving the securitization of school fees and an infrastructure project. Nonetheless, the ABS market remains underdeveloped in the entire Central American region. There are only a few ABS transactions in the neighboring countries of Panama, Costa Rica and Guatemala.

G. Equity Market

20. **Cumbersome registration processes and the firms' ownership structure and size discourage new equity issuance.** There have been very few initial public offerings (IPOs) in recent years. For example, there were only one, three, zero, and one IPOs in 2006, 2007, 2008, and 2009, respectively (Table 1). This is partly due to cumbersome approval processes and the dominance of small- and medium-sized family-owned companies which lack interest in becoming public. Issuers have to list with the BVES before registering with the SV. Although both entities essentially have the same requirements; they conduct their own reviews of the information submitted. The approval process is often perceived as inconsistent in the implementation of regulations and requiring excessive information. Issuers feel that the dual listing and registration process is cumbersome and not cost-effective. The protracted approval process has caused some large domestic companies to circumvent local registration by seeking listing abroad and registering as foreign securities in the local market.

21. **Weak corporate governance practices also hamper market development.** According to a World Bank Corporate Governance ROSC assessment, minority rights are mostly limited to the framework established in the Commercial Code for all joint stock companies. A code of corporate conduct for listed companies has not been developed. Tender offers are not mandatory for the acquisition of control in a listed company and there is no minimum float requirement. In addition, ongoing disclosure requirements have some gaps such as a lack of timely disclosure of material events. Insider holdings are only disclosed when they reach the threshold of a substantial holding.

H. Regional Integration

22. **Given the limited number and size of issuers and investors, there is very limited scope for developing individual country capital markets in Central America.** Both large and global investors are unlikely to be interested by the meager offering choices in these markets where issuance sizes range from \$50-\$100 million⁵. While incentives such as tax breaks and favorable disclosure and approval standards can spur some additional issuance, the demand for these securities from retail and institutional investors is tempered. The unattractiveness of these individual markets to domestic and global investors, and the ease of investing in nearby developed markets (such as the US) suggest that these individual markets may be unviable even with regulatory reforms, shifts in ownership and investment culture, and growth in GDP.

23. **While regional integration of capital markets is neither a panacea nor guaranteed to succeed, the various structural issues related to the sustainability of individual capital markets makes it worth exploring.** Regional markets may build the capacity to absorb larger individual issuances, and integrated market infrastructure may offer investors greater scope for diversification in their portfolio. Regionalization is likely to enable these markets to gain critical mass that will make it profitable to invest in sophisticated market infrastructure. Central American capital markets may want to look into other international experiences with integrating capital markets.

24. **Both regulators and stock exchanges have taken measures towards regional integration of securities markets.** These measures have been documented in an IMF study⁶. Countries with the most developed securities markets, such as Costa Rica, El Salvador, and Panama, have been most active in this effort. However, so far their efforts have produced limited results. The main steps taken on regional integration are summarized below based on the same IMF study and additional recent information.

⁵ These markets offer few liquid stocks and have a small market capitalization. The three better-developed markets of Costa Rica, El Salvador and Panama collectively offer 90 stocks, most of which are illiquid. At the end of 2006, the total market capitalization was US\$16.4 billion, with only 15 stocks accounting for US\$11.4 billion.

⁶ Equity and Private Debt Markets in Central America, Panama, and the Dominican Republic, IMF 2007.

Box 1. Initiatives for Central American Capital Market Integration

Initiatives from Regulators

Regulators from Costa Rica, El Salvador, and Panama have attempted to expedite the approval of primary issuance of securities and mutual funds in each other's jurisdiction on a bilateral basis, with limited success. In 2003, El Salvador and Panama signed a memorandum of understanding (MoU) that was expected to facilitate "fast track" registration. Panama also granted El Salvador the status of recognized jurisdiction. However, despite this mutual recognition, Panamanian firms have faced additional regulatory requirements while enlisting securities in El Salvador. In 2003, El Salvador and Costa Rica signed another MoU designed to facilitate streamlining of the registration process but did not proceed further than a diagnostic of the issues.

There has been a proposal to create a Central American Institute of Securities Markets to foster regional integration, similar to the Spanish Instituto Iberoamericano de Mercados de Capitales. The regulators have so far agreed to create a council of Central American superintendents to explore lessons that can be drawn from global experiences with capital markets integration. A new initiative led by the regulators and supported by the Inter-American Development Bank (IADB) aims to assess in detail the regulatory changes needed in each of the countries' frameworks to be able to harmonize their regulations around the IOSCO standards.

Initiatives from Securities Exchanges

Exchanges have initiated their own efforts to promote regional integration of markets. In 1994, Bolcen, the Association of Central American and Caribbean stock exchanges, was created to achieve the goal of a single market with interconnected exchanges. The exchanges of El Salvador, Costa Rica and Panama initiated the AMERCA project to allow brokers from the two of the countries remote access⁷ to the third country's jurisdiction. However, currently only Panama has the authority to grant such access, while El Salvador and Costa Rica would require reforms to their capital markets laws to achieve the same.

There has been a parallel effort in these countries to develop a common trading platform that would allow real-time trades in all three markets through local brokers. The integration of market infrastructure was expected to spur regulatory action. However, lack of consensus and technical issues such as disparate settlement conventions have hindered progress, spurring them to seek technical support from OMX⁸. In addition, the Panama Stock Exchange is exploring an order routing system with South American countries that would equip local intermediaries to place orders on securities listed on foreign exchanges for a fee.

25. While a moderate regional integration effort has been made, any significant progress would require relevant legal changes. The possibility of a more aggressive process of integration is very unrealistic in the short term given the very uneven state of their regulatory frameworks, of which El Salvador has the lowest standards.

⁷ Remote access allows a brokerage house from a given country to directly access the electronic trading platform of the other countries' exchanges and buy or sell securities listed in those markets.

⁸ OMX is a financial services company, world leader in financial instruments trading systems.

II. REGULATORY AND SUPERVISORY FRAMEWORK

26. **The weak and outdated legal and regulatory framework for the capital markets constrains local debt market development.** The Securitization Law has been the only significant regulation issued in the last decade. The Investment Funds Law has been in formulation for more than 10-years. The Law aims to regulate mutual funds, the shares issued by them; their manager companies, and its operations in general. The main elements of the Law include (i) regulation about the establishment, merger, dissolution and liquidation of the fund management companies; (ii) a regulatory tax regime for mutual funds; and (iii) marketing of foreign investment funds. Legislation to modernize the capital markets architecture has been put on hold since 2005 due to differences in views between the government and the BVES. It is true that an underdeveloped market is in many cases partially responsible for a weak regulatory framework, situation that creates a vicious circle for the system and becomes a major challenge in developing capital markets in many emerging markets. It is however a responsibility of the government to break that situation and create the environment that will induce the development of the markets that the country requires.

27. **The merger of the existing superintendences, all of them with share responsibilities over capital markets, could improve supervision but their effective integration could take time and could potentially distract the reform agenda.** Three different superintendence's are relevant to El Salvador's capital markets. They include (a) the Superintendence of Securities (SV), (b) the Superintendence of the Financial System (SSF), which regulates banks and financial institutions as issuers; and (c) the Superintendence of Pensions (SP), which regulates pension funds as institutional investors. The decentralization of supervision and decision-making for such a small market may have a negative impact on the efficiency and consistency of the system. A draft Law currently under Parliamentary review would merge the three superintendencies. The merger would facilitate consolidated supervision and reduce the scope for regulatory arbitrage. However, effective integration will likely take time and it is essential to ensure that capital market issues are given appropriate importance and are not subordinated by the banking sector agenda and the integration process itself.

28. **The supervisory capacity of SV is weak partly because the regulator enjoys only limited independence and self-funding.** The budget of the SV and personnel contracts is subject to the MoF's approval. The salary scales of SV are also restricted by the application of civil service rules. SV has difficulty in attracting and retaining qualified staff.

29. **BVES is a Self Regulated Organization (SRO), although this function does not appear to be performed effectively and this role should be rethought.** According to the current regulatory framework, the securities exchange is de facto the only self-regulated organization that is recognized in the market and is technically under the supervision of the SV. However, there is no clear division of responsibilities between the SV and the BVES. In practice, the BVES is not properly performing the function of a SRO⁹. Given the size of

⁹ According to IMF 2007b

the market, the usefulness of a formal two-level regulatory structure (regulator and the SRO) is questionable from a cost/benefit perspective. In addition, the current corporate governance of the BVES does not comply with international best practice, as the owner of a brokerage firm acts as the CEO of the BVES, which could create potential conflicts of interest.

30. **The supervisory framework presents very low levels of compliance with the international standards in several areas of high concern, and little progress has been made to address them.** In 2004 and 2005 a series of very detailed assessments of the regulatory and supervisory framework were conducted by the IOSCO secretariat and by the US SRO (FINRA) that highlighted very low compliance vis-à-vis the international best practices (IOSCO principles). In particular the areas that were identified of higher priority were the whole governance and capacity of the regulator to conduct supervision and enforcement, investor and systemic risks of the collective investment schemes, the need for an update of the overall regulatory framework (laws and rules), the lack of risk oriented supervision, and weak supervision of the brokers and surveillance of the markets. Over the past five years, some measures have been taken in the area of the compliance of the intermediaries with accounting and information standards and in the area of consumer protection, but overall limited progress have been made on all the major fronts identified in the independent assessments. This lack of compliance becomes more acute when compared with some of the other potential partners in the region such as Costa Rica and Panama.

III. RECOMMENDATIONS

31. **There is an urgent need to overhaul of the regulatory framework to promote sound market development in the short-to-medium term.** The updating of the regulatory framework would facilitate the matching of supply and demand of resources and the promotion of sound market development. Such reform should be followed by a comprehensive strategy aimed at subordinating the role of the Exchange to such a goal. These necessary changes constitute the primary reforms to be included in a new and comprehensive Securities Law and relevant pension, insurance, and banking regulations. These changes aim to elevate the standards of the market, enhance the capital market's role in the economy and facilitate regional integration. These include:

- Eliminating obligations for listing and trading on the Exchange starting initially with fixed income products and foreign securities from recognized jurisdictions;
- Allowing private placements, targeting institutional investors (registered in the SV), and OTC transactions to develop in the country;
- Eliminating local rating requirements for rated foreign instruments from recognized jurisdictions;
- Granting the government with powers to make the regulatory changes needed to expedite regional integration (e.g. remote access, mutual recognition); and
- Redesigning the self-regulatory framework currently in place to formally minimize its use given the small size of the market and the demutualized nature of the Exchange.

32. **The regulatory framework should guarantee a level playing field between bonds and bank deposits, which should be reflected in the investment guidelines for institutional investors.** In addition to the ambitious process of improving the overall regulatory framework for the capital markets, the government should also review the prudential guidelines of institutional investors with the objective of creating a level playing field between bonds and banks deposits.

33. **The Exchange should reposition itself to become more competitive and strategic at the local and regional level.** The Exchange should be reformed to strengthen its function as an infrastructure provider (depository, trading systems and information vendor) and to elevate its corporate governance standards; as the primary listed company in the country it should lead by example. The government should also provide strong support to the process of integrating with other Exchanges in the region.

34. **The Investment Funds Law should be finally approved to broaden and diversify the investor base.** The importance of this reform is paramount as the current reliance on just two main institutional investors (banks and pension funds), with investment limitations (35 percent each per issue), creates a major limitation for new issuances. Some improvements could be quickly introduced to the current draft including (i) extension of the concept of the oversight board to the open funds, (ii) allowing pension funds to invest in investment funds with foreign assets up to a limit of 20 percent.

35. **In the medium -to long- run, it is recommended to explore gradually integrating the individual markets at the regional level.** In order to do so it is necessary to harmonize the regulatory frameworks and facilitate the consolidation of the market infrastructure.

36. **Strengthen public debt market development by adopting the following strategy: (i) in the medium -to long- run, facilitate an integrated regional government securities market. Each individual government will be one of the issuers in regional integrated market; (ii) in the short-run, focus on the following specific reforms:**

- Strengthen the transparency of the primary market by establishing and publishing an issuance calendar; however, close consideration should be given to the fact that if the volumes are not significant and the demand continues to be too concentrated in very few investors, the government could consider putting in a place alternatively a program of frequent issuance of modest amounts (Tap issuance) as a transitional measure.
- Harmonize and strengthen coordination on issuance between government securities and central bank securities;
- Develop a benchmark-securities oriented issuance strategy in the medium-term by (i) gradually increasing the volume of domestic debt in relative to the Euro market. Volumes and benchmarks should be consistent with the absorption capacity of domestic institutional investors as well as the long-term strategy to strengthen liquidity in the domestic market; (ii) streamlining non-standardized instruments into standardized instruments;

- Develop an OTC market to facilitate whole-sale public debt transactions; and
- In the short run, consider adopting an external yield curve to facilitate the valuation of the portfolios, while a local yield curve gets built in the medium-term. For example, adopting the US yield curve as the reference rate would facilitate the valuation of different portfolios while the government gradually develops its own curve, through a series of improvements in the debt management capacity of the MOF or through the outsourcing of such functions to the Central Bank.

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