Market-Based Financing in Emerging Market Countries

ICSA Emerging Markets Committee

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I. Overview and Summary

Financial markets primarily favor one of two financial systems: bank-based, and market-based. “In the bank-based system, the banks play a leading role in mobilizing savings, allocating capital, overseeing the investment decisions of corporate managers, and providing risk management vehicles. In contrast, in the market-based system, securities markets work in conjunction with banks to get the public's savings to firms, exert corporate control, and ease risk management.”(Demirgüç-Kunt, 1999)

Determining which system is preferable for a market to adopt requires taking a number of factors into account, such as the relevant policies, culture, infrastructural development, and key industry sectors of the nation in question. Traditionally, studies[1] have shown that countries which base their legal system on Continental European Law, such as Germany and Japan, tend to rely more on bank-based financing, whereas Civil Law Countries, such as the United States and United Kingdom, favor equity trading and financing through the capital market. The rationale behind this is that Civil Law Countries tend to have more advanced accounting systems and protections on shareholder rights in place in their capital markets.

It is also generally accepted that developed nations and higher income countries are more market-oriented than developing countries, because the financial sophistication (financial literacy) of households and companies rises as economic development increases, elevating demand for services linked to market-traded securities. (Allen, 2000)

Globally, shifts from a bank-based to a market-based system have been witnessed in both emerging markets and developed countries. Emerging countries such as Brazil and Mexico, which traditionally had a heavy dependence on bank-based financing, have been making a gradual move toward market-based financing.

As emerging markets continue to move towards a more market-based financing model, having a resilient and transparent securities market with reasonable regulations in place is essential to ensure that the global economy is soundly functioning and efforts to drive the recovery are successful. It was witnessed during the global financial crisis that highly developed financial market is not always functioning well: introduction of a more complex, opaque, and illiquid product threatened the market integrity.

Despite of downfalls, a significant number of emerging market countries are aiming to develop their securities market as a key channel for corporate funding even after the crisis. Having a diverse range of options to raise corporate capital helps to strengthen the financial structure of corporations; this in turn leads to greater transparency in terms of corporate management. Market-based financial system has already proven itself useful especially in the infrastructure sector and funding for SMEs in various studies. Asian corporate debt issuance has seen a great deal of growth, especially in China, and Islamic bond (sukuk) financing has also been on the rise. In line with this diversification of

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[1] Demirgüç-Kunt, A and R Levine (1996): “Stock market development and financial intermediaries: stylized facts”, *World Bank Economic Review*, no 10, pp 291–322.

------------------------------------ (2001): *Financial structures and economic growth: a cross-country comparison of banks, markets and development*, Cambridge, MIT Press.

financial products, companies located in emerging markets have also been issuing securitized products to reduce costs by enhancing associated credit rates, which increases liquidity and thereby enables the effective management of associated risks.

This report focuses on the history, current status, regulatory framework and characteristics of market-based finance in Thailand, Turkey, Korea, India, Mexico, and Taiwan. Below, our major findings are summarized, and a report from each country is presented afterward.

II. Mandate

Considering the changing trends in financial intermediation systems and increasing emphasis on the role of market-based financing in the global economy, ICSA's Emerging Markets Committee (EMC) conducted a study on market-based financing in emerging market countries. The EMC's proposal was approved by ICSA members during the Interim Meeting held in October, 2014 in Rio de Janeiro, Brazil.

ICSA's EMC is chaired by the Korea Financial Investment Association (KOFIA), with the committee being composed of the following members:

1. Turkish Capital Market Association (TCMA)
2. Asociación Mexicana de Intermediarios Bursátiles (AMIB)
3. Association of Thai Securities Companies (ASCO)
4. Brazilian Financial and Capital Markets Association (ANBIMA)
5. Bombay Stock Exchange Brokers' Forum (BBF)
6. Taiwan Securities Association (TSA)

III. Findings

1. Market-based vs. Bank-based Finance System

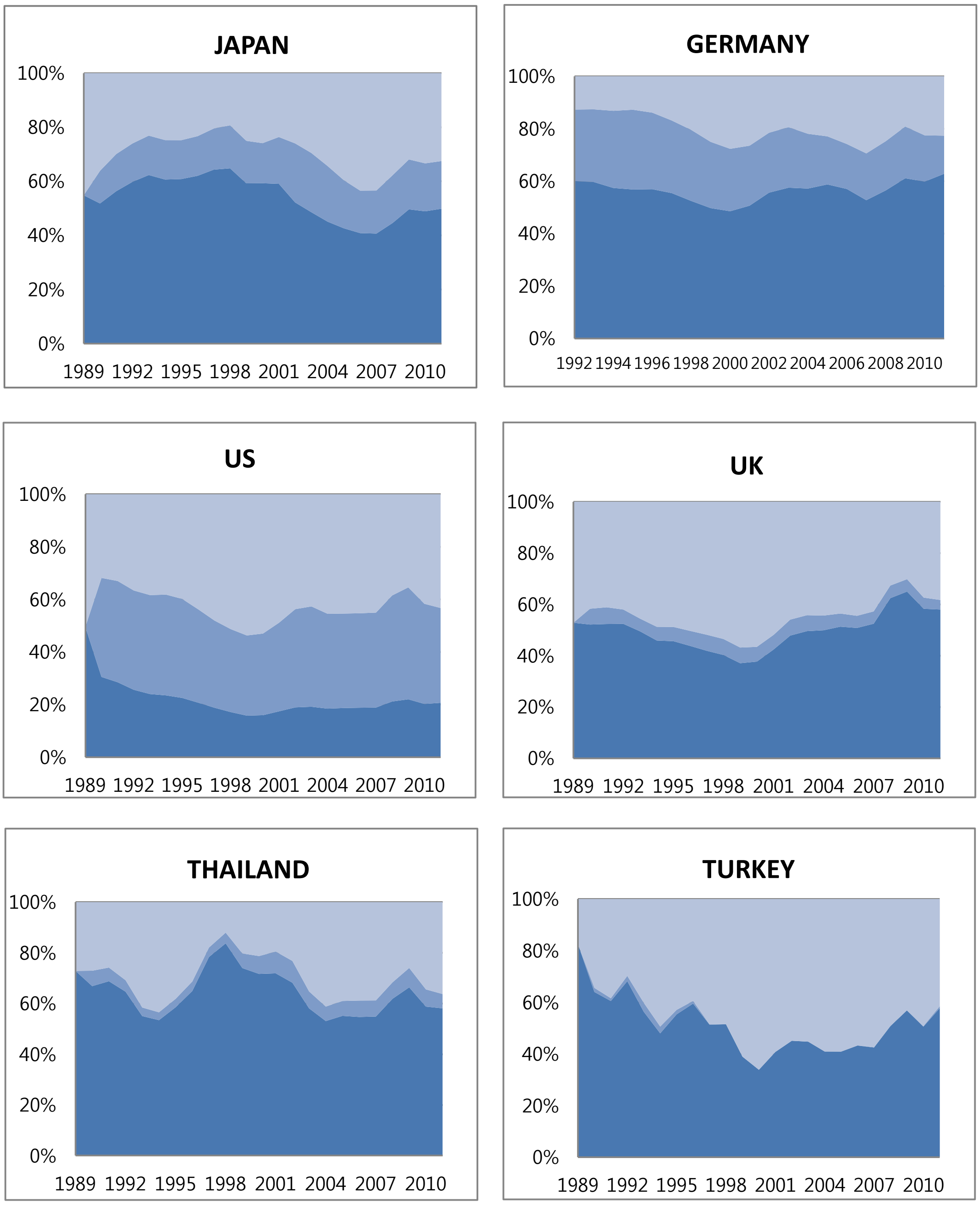
Developed countries with the Continental European Law as their legal system, such as Germany and Japan, displayed a strong preference for a bank-based financial system throughout the observed period.

In the case of Japan, bank-based financing is still dominant. Interestingly, however, since the Financial System Reform, the so called "Japanese Big Bang" took effect in 1996, with the aim of transforming the highly regulated, bank-oriented financial system into a more transparent, market-based financial system, bank-based financing and market-based financing are well balanced until recently, each owning up to approximately 50%.

On the contrary, in developed countries under the civil law legal system, such as United Kingdom and United States, preference for market-based financing is clearly demonstrated in the observed period.

<Financial Intermediation of Selected Countries[2]>

Stock Market Capitalization[3]
Private Bond Market Capitalization[4]
Private Credit by Deposit Money Banks and Other Financial Institutions[5]



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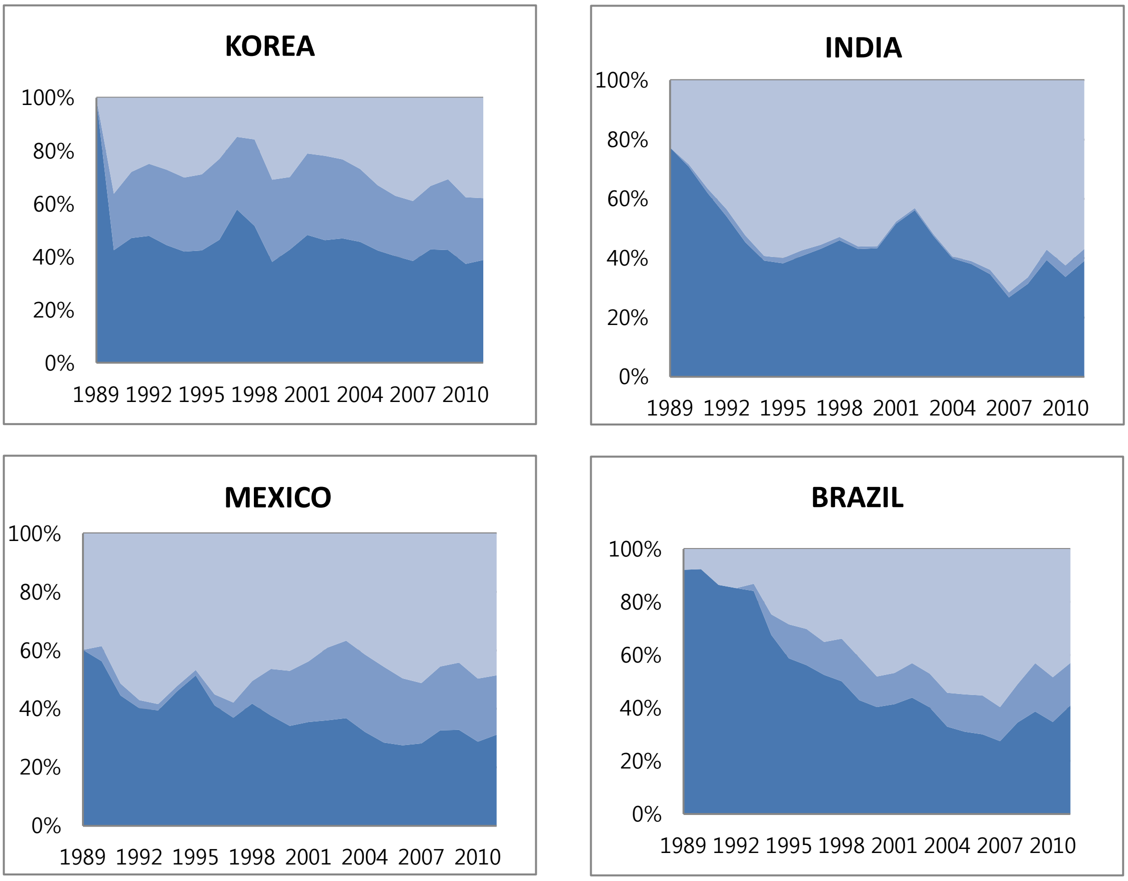
[2] Selected advanced countries and EMC countries except for Taiwan, as World Bank doesn't provide data for Taiwan

[3] Value of listed shares

[4] Private domestic debt securities issued by financial institutions and corporations

[5] "Other financial institutions" comprise (a) bank-like institutions (including, e.g. savings banks, cooperative banks, mortgage banks, building societies, and finance companies), (b) insurance companies, (c) private pension and provident funds, (d) pooled investment schemes and (d) development banks.(OECD, 2012)



Source: World Bank Database

Theoretically, emerging market countries are perceived to rely on bank-based financial intermediation rather than market-based financing. Previous studies showed that in developing countries with low income, most of the financial intermediation is handled by banks, since confidence in the legal and capital market systems is generally perceived as weak (Demirgüç-Kunt, 1999). However, it was observed that, with the exception of Thailand and Turkey, emerging market countries are shifting from bank lending to market-based financing.

The following six reports from EMC member countries summarize the current developments for market-based financing in their respective markets. Additionally, some members have provided a more detailed analysis of specific cases, such as, for example, the introduction of infrastructure funds, third market for SMEs and etc.

THAILAND

On the financial sector front, the Thai financial system is still bank-based, with Thai banks making up the majority. After the Asian Financial Crisis in 1997, the Thai government placed significant restrictions on the functions and activities of financial institutions to aid with the recovery process. Even though the government took action to reform financial regulations in 2004, non-bank financial institutions still only make up a small proportion of the financial industry.

In order to further address the development and diversification of the Thai capital market, the Thai government developed the Capital Market Master Plan (CMMP).

The plan was drafted with an emphasis on meeting the needs of all financial service users, given that there is a need to improve the corporate governance, financial infrastructure and supervision systems as well as increase the investor base.

Case Study: Infrastructure Fund

As at the end of Feb 2015, there are 4 infrastructure funds in Thailand;

Name	Launch Date	Size
BTS Rail Mass Transit Growth Infrastructure Fund	Apr 2013	USD 1,880 million
Amata B. Grimm Power Plant Infrastructure Fund	Sep 2013	USD 167 million
True Telecommunication Growth Infrastructure Fund	Dec 2013	USD 1,760 million
Jasmine Broadband Internet Infrastructure Fund	Feb 2015	USD 1,583 million

Characteristics

The Infrastructure Fund is a mutual fund allowing the country to finance large infrastructure projects; e.g., electricity, water, airfields, transportation systems and roads, etc., which help reduce the budgeting burden and public debts for the government sector, which indirectly enhances the economic growth, boosts long-term national competitiveness, provides other sources of fund-raising to the private sector and offers one more investment alternatives for institutional and public investors.

The Infrastructure Fund is a juristic person whereby the management company shall have the duties of establishing the fund, and offering for sale investment units to the public, both local and foreign investors. After fund-raising, the fund shall invest in projects owned by state enterprises, private companies or government agencies responsible for infrastructure development; e.g., expressways, motorways, power plants, water treatment plants, airports, railways, deep sea ports, telecommunications systems, etc., so that the investment is in line with the investment policy formulated by the infrastructure fund. The management company may also enter into a revenue purchase and transfer agreement to distribute some proceeds received from future operating results of these infrastructure projects; e.g., fare-box revenues, tool fees, revenues from sales of electricity, etc., to the fund's investors according to the amount and period agreed therein.

Cash inflow from the infrastructure fund shall become a crucial source of capital for any state enterprises, private companies or government agencies for infrastructure project owners to develop the projects or repair the damages. This reduces their debt financing from banks or waiting for the government's limited budget.

Regulations

The Infrastructure Fund is governed by the Securities and Exchange Commission (SEC). Infrastructure projects that can raise capital via the Infrastructure Fund:

- Rail transit systems;
- Electricity;

- Water;
- Roads, highways, and concession ways;
- Airfields and airports;
- Deep water ports;
- Telecommunications;
- Alternative energy;
- Water management systems and irrigation systems;
- Natural disaster protection systems, which includes warning and management systems to mitigate the severity of natural disasters that have occurred.

Benefits

Benefits to the country:

- Adds another financing source for the development of infrastructure projects; each of them enhances benefits for the public such as electricity, water, energy, transportation systems, expressways, etc.
- Provides the government sector with greater investment capacity in infrastructure projects without creating public debt or borrowing from banks.
- Helps the private sector, which may enter into business or concession agreements with the government sector, to raise funds from current projects for the development of new projects or to raise funds from new projects where such capital-raising is more worthwhile for larger and quicker investments in other infrastructure projects.

Benefits to investors:

- Provides an alternative fund raising scheme, and offer returns relevant to investors' expectations.
- Offers tax incentives to attract unit holders who are individual persons, as they shall not be taxed from sales of investment units, and they shall be exempted from the dividend tax for 10 years upon the establishment of the fund.

Benefits for private sector:

- Gains tax benefits, and raises funds with a lower financial cost but higher business value.
- Able to realize profits from sales of current projects; so the capital base is stronger.
- Hastens the acquisition of benefits from infrastructure projects, that is, the private companies may perform the duties of project developers fully whilst the investors gain the long-term benefits on a continuous basis.

Challenges

Infrastructure funds have many attractive investment characteristics, as well as supportive tax and regulatory frameworks. The size of infrastructure funds in Thailand is expected to grow rapidly in the future.

TURKEY

The Turkish financial system is bank-dominated. Market-based financing in Turkey is still on the path to development. For instance, in 2014, the market capitalization to GDP ratio was around 30%, whereas the loan to GDP ratio was around 70%. Out of $673 billion in total savings, equities and fixed income instruments represented a 33% share as of December 2014.

Breakdown of Total Savings ($ bn.)	Deposits	Fixed Income	Equities	TOTAL
2010	401	71	107	**580**
2011	368	81	74	**523**
2012	434	121	120	**675**
2013	444	106	92	**642**
2014	452	114	107	**673**

Source: Banking Regulation Supervision Agency, Central Registry Agency,TCMA

One of the main macroeconomic obstacles for Turkey is low level of saving rates. Not only is it relatively subdued compared to emerging economies but it also exhibits a declining trend in the last decade.

Gross National Savings (percent of GDP)	
2004	15.8
2005	15.5
2006	16.0
2007	15.2
2008	16.3
2009	13.0
2010	13.3
2011	13.9
2012	14.0
2013	12.6

Source: TurkStat

Regulations

In Turkey, there have been new regulatory actions and laws implemented to foster market based financing, which are detailed under the following subtitles. There are some major initiatives towards establishing a more developed financial market in Turkey.

A landmark project called Istanbul International Financial Center (IIFC) was made public in 2009 with the purpose of establishing Istanbul as one the global financial center. In July 2014 a new strategy and action plan was released after the one that had been released in October 2009.

The Prime Ministry also released a strategy and action plan for "Financial Access, Financial Education and Financial Consumer Protection" in June 2014. The plan mainly aims to convey financial knowledge to all layers of the society and to enhance product and service diversity, and financial consumer protection for a sounder and fair financial environment.

- **New Capital Market Law**

The former capital market law had been in effect since 1981. Not only was it inadequate for meeting investors' needs, but it also did not function well to capture the fast-paced innovations taking place globally. In addition, the introduction of a new Turkish commercial code increased the need for compatible legislation for the capital markets as well. The new capital market law adopted in December 2012 aims to modernize the capital market legislation as well as compliance with international standards and EU regulations.

The new law departs the institution-based approach in favor of an activity-based approach. In that regard, the new regulation defined the three types of intermediaries as: Introducing Broker, Limited Service Broker and Full Service Broker. This would be effective starting from July 2015.

In parallel to those new types of firms defined, another important change introduced by the new capital markets law will be a rise in the minimum capital requirement for financial institutions starting from July 2015. Minimum capital for investment companies will vary between $1 million and $11 million, which implies a two-fold increase compared to the current requirements. In the asset management industry, on the other hand, the increase in the minimum capital requirement is more dramatic, from around $200,000 to a minimum of $1 million. The regulator does thus envisage a stronger capital base for market institutions.

- **Borsa Istanbul demutualization**

Another recent development in the regulation side is the demutualization process of Borsa Istanbul, which took place in 2013. Within this context, the exchanges operating in Turkey, namely the Istanbul Stock Exchange, Istanbul Gold Exchange and the Turkish Derivatives Exchange, merged under the roof of Borsa Istanbul during 2013. Under this new structure, all securities, bonds, derivatives and precious metals are traded on Borsa İstanbul. In addition, Borsa Istanbul announced a strategic partnership with NASDAQ in 2013. Moreover, an energy exchange is expected to be introduced in the near future. This market will operate under Borsa Istanbul. Along with Takasbank (central depository), The Central Registry Agency, which is the central securities depository for capital market instruments, is affiliated with Borsa İstanbul. Thus, Borsa Istanbul has achieved the integration of all markets and post-trade operations recently. Furthermore, the IPO of Borsa Istanbul is expected to take place in 2015. Overall, recent reform regulations are considered to be key steps in upgrading the market's structure for both foreign and local investors.

- **Private debt security market**

Favorable macroeconomic conditions, such as lower inflation and sustainable public debt, the revised and simplified regulations and the removal of discrepancies in taxation have revived the private debt security market since 2010.

- **Emerging companies market**

For the aim of easing funding alternatives for SMEs, the regulations for the Emerging Companies Market (ECM) were released in August 2009, and the market, run by Borsa İstanbul, became operational in October 2010. The ECM is designed for companies with high growth potential which fail to meet the listing criteria for the stock market.

Benefits

Thanks to recent reforms, there has been a significant increase in corporate bond issuance in the last 5 years. 517 corporate bonds were issued in 2014. The outstanding volume of corporate bonds approached $19 billion as of end-2014, from only $2 billion in 2010. Although financial institutions are the major actors which have benefited from the debt securities market, the share of non-financial companies has been on the rise recently.

Corporate Bonds

	No. of Securities Issued	Size of Securities Issued ($ bn.)	Outstanding Bonds ($ bn.)	No. of Investors (thou.)
2010	15	1.3	1.9	5
2011	58	11.1	7.8	119
2012	235	23.3	15.6	194
2013	341	29.2	14.9	173
2014	517	33.3	19.3	138

Source: Borsa Istanbul, CMB

The IPO market has been sluggish in terms of volume since 2009. This is due to the fact that new IPOs mainly took place on the Emerging Companies Market. The first company on the ECM was listed in January 2011. At the end of 2014, 23 companies, with a total market capitalization of US $421 million, were listed on the ECM.

Initial Public Offerings

	2010	2011	2012	2013	2014
No. of IPOs	**25**	**27**	**30**	**19**	**13**
Equity Market	17	22	15	6	8
Emerging Companies Market	-	2	10	9	4
Investment Trusts & ETFs	8	3	5	4	1
IPO Volume ($ mn.)	**2,115**	**842**	**362**	**758**	**320**
Equity Market	958	616	241	505	300
Emerging Companies Market	-	15	49	33	11
Investment Trusts & ETFs	1,157	211	72	221	9

Source: Borsa Istanbul

Challenges

A downward trend in the savings rate has been observed in the last decade. The ratio has been around 13-14% since 2009. This situation is considered to be a crucial macroeconomic issue limiting the expansion of financial markets. Banking sector dominance stands as one of the main obstacles towards more developed market-based financing for the Turkish financial market. The number of investors in the Turkish capital market is considerably low. Though the pension funds have almost 5 million accounts, there are only 1.1 million investors in the equity market. On the other hand, the number of deposit accounts approached 61 million.

Due to bank dominance, the distribution channels of bank-based financial institutions have a respected place. However, non-bank distribution channels have not developed that much to support capital market activities.

Last but not least, another point that should be mentioned concerns the low level of financial literacy and insufficient investor education. Most investors do not have sufficient knowledge of investment instruments or financial institutions. More importantly, there is a lack of awareness of investor protection mechanisms, such as the Investor Compensation Center. Therefore, investor confidence has to be strengthened, coupled with attempts to enhance financial literacy.

KOREA

Since the Asian Financial crisis in 1997, the Korean government has had a mission to restructure its financial system, and the most important pillar of this restructuring was to boost the Korean securities market, thereby improving the mechanism for fund-raising for corporations, and improving corporate governance as well as transparency in corporate management.

Essentially, this so-called Financial Reform Act originated from the IMF Stand-By Arrangement after the crisis. The IMF believed that the root of Korea’s currency crisis was deeply associated with inefficiency in the banking mechanisms for capital lending and corporations lacking transparent management practices. Thus, there was a great demand for the Korean capital market to be revitalized in exchange for emergency funding.

With the reform act in place, the Korean government actively pushed for a series of financial rules and regulations to be established to enhance the securities market. IPO and listing requirements were largely deregulated, and the KOSDAQ market was launched to supply direct funding for SMEs.

Since 2004, the capital market has undergone a revolutionary reform in terms of shifting its function from merely supporting other industries into a high value-adding industry in itself. Since the Asian financial crisis, foreign portfolio investments in the domestic securities market have surged dramatically, which in turn has made domestic institutional investors suffer from reduced profits, spurring the creation of short-term investments with lowered trading commissions. Therefore, measures to stabilize the securities market were required.

In December 2004, the Framework Act on Fund Management was enacted, which allowed the National Pension Fund and Pension Funds to invest in the stock market. In July 2005, the Trust Business Act was revised to permit securities companies to engage in trust business activities, and retirement pension plans (similar to the US 401(k) plans) were introduced with pension funds permitted to invest in the stock market, pursuant to the Employee Retirement Benefit Security Act.

A series of efforts to improve market infrastructure and financial laws were introduced to make the securities business a high value-adding industry. In January 2005, the KRX, a consolidated exchange that integrated the operations of the KSE, KOSDAQ, and KOFEX markets, was launched pursuant to the Korea Securities and Futures Exchange Act of January 2004. Later in July, FreeBoard, a third market for non-listed stocks, was established to support promising venture companies and SMEs. Finally, in December 2007, the Bond Quotation System (BQS) was introduced to enhance transparency and liquidity in the OTC bond market.

More recently, the Financial Investment Services and Capital Markets Act (FSCMA), a revolutionary act that introduced a single consolidated legal framework, was enacted in 2009 to significantly reinvigorate Korea's capital market, allowing for the creation of new financial products and enabling securities companies to engage in other financial services as well.

In 2011, the government announced its intention to revise the FSCMA in order to further innovate and improve the capital market by allowing the nurturing of advanced investment banks and introducing hedge funds. These revisions aim to fulfill the original purpose of the Act – deregulation – which had not been fully satisfied at the early stages of its enforcement due to the global financial crisis. As a result, the partial revision of the Enforcement Decree of the FSCMA led to the launch of "Korean" hedge funds. In line with this change, the government also modified relevant regulations, enforcing more reasonable Chinese Wall policies in the prime brokerage business and relaxing credit extension limits for hedge funds.

The year 2013 saw major changes in laws and regulations regarding the capital market. First of all, laws on large IBs, the Alternative Trading System (ATS), and the OTC Central Counterparty (CCP) were legislated in 2013, which is viewed as great progress considering the fact that financial regulatory authorities have been pushing for these changes in order to transform the financial environment and advance the financial industry since 2011. In addition, the Korea New Exchange (KONEX) was launched, and is expected to facilitate financing of small- and medium-sized local venture companies in their early stages.

All in all, the pattern for corporate fund-raising and the structure of the financial market have gone through a major transformation, which played a key role in shifting Korea's financial system from a bank-based to a market-based financing model.

Case Study: Creation of K-OTC

The government has been making consistent efforts to boost the OTC market by initiating a range of policies targeting the capital market, which is essential for the financing of SMEs and venture companies.

When KONEX (Korea New Exchange) was launched in July 2013, in order to facilitate the financing of small- and medium-sized venture companies, the government began making efforts to overhaul FreeBoard – the OTC market for SMEs and venture firms, used to be ran by KOFIA. The aim was to provide a practical venue in which all unlisted stocks, including those of SMEs, can be actively traded in a transparent manner. The K-OTC was launched on August 25, 2014.

The K-OTC is an institutionalized OTC market established and operated by KOFIA pursuant to the FSCMA for the trading of stock certificates that are not listed on the stock market. Stocks from 114 unlisted corporations are traded, with an average daily trading volume of KRW 2.5bn.

The K-OTC market will contribute to ensuring that investors can trade unlisted stocks on a transparent, regulated market, as opposed to through the underground economy, by funneling the stocks of unlisted corporations that are required to submit annual reports, such as Samsung Medison, Jeju Air, and Mirae Asset Life Insurance, onto the exchange.

【 K-OTC Overview 】

	2011	2012	2013	2014 (before 8/22)	2014 (after 8/22)
No. of Corporations (end of year)	63	52	52	48	114
Market Cap. (trillion won)	0.86	0.59	0.62	0.5	13.48
Av. Daily Trading Vol. (1000 shares)	258	145	128	78	480
Av. Daily Trading Value (1000 mil won)	2	1	1	0.9	25.5

Entrance & Revocation Conditions

The requirements were relaxed overall compared to the market for listed stocks. Entrance conditions were alleviated and revocation conditions were limited to a small number of cases, including when a corporation can no longer sustain itself.

Trading Methods

The K-OTC Market adopted negotiated trading, in which a trade is executed only when the offered price and the bid price match. This is comparable to the listed market, which adopted the method of competitive bidding.

Disclosure System

Registered corporations shall submit periodic disclosures, timely disclosures, and inquired disclosures, while designated corporations, subject to submitting annual reports, must provide information to investors via the FSS DART system.

Tax

Settlement and securities transaction taxes are automatically collected via the Korea Securities Depository, like on the listed market.

Benefits of the K-OTC

The convenience of stock trading will be enhanced with the creation of a reputable venue where investors can actively and transparently trade unlisted stocks. In addition, investor losses that occur in private direct trading will be reduced.

The active trading of stocks issued by unlisted corporations through the K-OTC market is expected to facilitate direct financing of corporations.

The infrastructure for trading unlisted stocks will be also bolstered, which in turn will lead to the advancement of the capital market.

A new profit base for securities companies, including the intermediation business for unlisted stock transactions, will be created and expanded.

In addition, the K-OTC will bring the underground economy out into the open by promoting the transparent trading of OTC stocks. When stocks are traded on the K-OTC, the transaction tax is automatically collected and the tax revenue coming from the capital gains tax becomes more transparent.

INDIA

The Indian economy has witnessed a paradigm shift in the last 3 decades, after opening up in 1991 and adopting the three pillars of liberalization, privatization and globalization. Today, India has one of the fastest-growing economies in the world, with the most recent data for next year’s GDP putting it between 8.1% and 8.5%. The Indian economy has gotten back on track, with the current account deficit at just 1.3% of GDP, and the government is taking firm steps to control the fiscal deficit. The current budget provides a huge impetus to the infrastructure sector, with the government having committed to spending an additional Rs. 70,000 crore as compared to the previous year. And, last but not least, the World Bank has also projected that the Indian economy will grow at the fastest pace in the world.

The 3 key features of the Indian economy which make it unique are:

1. 70% of the working population is under the age of 35, which means that the

economy enjoys a significant demographic advantage. A large amount of disposable income is available to the population, which leads to a consumption-driven economy. The average age in India is 25 years, whereas it is 37 in China, 38 in America, 47 in the European Union, and 50 in Japan.

2. Of total production, India consumes 80% of what it produces, and only 20% is exported. Thus, it is not an export-oriented economy, which reduces its reliance on other countries to maintain economic growth. At the same time, it is important for India to boost its exports, in order to fund imports of commodities such as gold and oil. Last year, India was able to reach $312 billion in exports against a target of $325 billion.

3. India's savings rate is 31%, while the global average is 24%. A high level of savings results in capital formation, which provides protection to the populace during weak economic times. A high savings rate also results in increased investment, helping to enhance capital formation.

Because of these unique features, the Indian economy is poised to grow and shows immense potential. It has also displayed tremendous resilience, as evidenced by the fact that it witnessed GDP growth of 6.3% while the world economy grew at just 1 to 2% during the global financial crisis.

In terms of the raising of funds, the Indian capital market presents companies with a wide range of opportunities. The Bombay Stock Exchange has opened an SME platform, where small- and medium-sized enterprises are able to raise funding for their business activities. The purpose of the platform is to encourage a culture of entrepreneurship, which in turn will lead to the creation of job opportunities. Our capital market also provides very good opportunities for foreign indirect investment. The year 2014 saw $16.5 billion flowing into the stock market. This allows companies to issue IPOs and hit the markets to raise capital, and companies which are already listed can raise capital through the OFS (Offer For Sale) method. For well-established companies with a sound track record, OFS is also a fantastic way to augment their fund-raising. In addition, the debt market provides numerous opportunities for companies to raise money. For instance, they can issue triple-A rated bonds and debentures, which offer attractive interest rates. This gives companies the opportunity to raise funds while, at the same time, investors can invest in high-interest-bearing instruments.

Thus, the Indian market provides ample equity and debt-raising options for companies.

MEXICO

Mexico's financial sector has undergone a major transformation over the last three decades. The shift from bank-based to bond financing (market-based financing) can be seen as the main contributor to this development. Mexico has substantially developed its domestic bond market and is now the second largest domestic debt market in Latin America in absolute terms, ranking just behind Brazil.

Mexico has carried out a series of structural reforms in recent years that are currently in the process of being implemented. The 2014 Financial Reform, which includes regulations for the stock exchange sector, has the following goals:

- To encourage the modernization of the sector's operations, stimulating innovation
    - This will allow the Mexican stock exchange to sign order-routing agreements with other stock exchanges. This was the reasoning behind the development of the Latin American Integrated Market (MILA), which Mexico recently joined.
- To provide incentives for listing medium-sized companies on the market
    - Changes have also been made to the regulations governing Public Limited Companies Promoter of Securities Investing (SAPIBs). Existing SAPIBs will be given a period of 10 years (instead of three years) to convert into Public Listed Companies (SABs) or meet a minimum capital stock of 250 million Units of Investment (UDIS).

This study will examine in detail the goal of providing incentives for listing medium-sized companies.

Characteristics

The Mexican stock market has been characterized in recent years by relatively low participation from companies, with the results not being representative of the market given the size of Mexico's economy, which is the 15th largest in the world.

While the market capitalization of domestic companies with respect to GDP is very high in other countries with similar economies, in Mexico, the market capitalization represents only 42% of the GDP.

The stock market has financed over $552 billion over the last 10 years. The debt market, which is the largest sector, has financed $470 billion, while $27 billion has been financed by the capital market, and over $15 billion is from the sector of new financial instruments such as Infrastructure and Real Estate Trusts (known as FIBRAs) and Capital Development Certificates (CKDs), which are becoming an important part of the stock market, as well as an important part of the development of sectors such as energy, real estate, infrastructure, private capital, retail, offices, hotels and manufacturing.

It should be mentioned that the recurrent crises of the last decades in Mexico have limited the growth of our markets. In addition to the fact that not all sectors of the Mexican economy are listed, the stock market is very concentrated, and the regulatory changes seen in recent years have not taken advantage of its growth potential.

Another existing problem in Mexico is the lack of awareness in the business community regarding how the Mexican stock market functions. There are also a large number of family-owned companies, where the directors have their own habits and fears about being subjected to regulatory obligations, revealing information and losing control of the company.

The perception also exists that the fees for being listed on the stock market are excessive, there culture of corporate governance is limited, and a conflict exists between the valuation of companies on the market versus the sentimental value for them. There are also accounting problems and a lack of fiscal stimuli, among other issues.

Regulations

With the goal of encouraging companies to list on the stock market, the Mexican government passed the 2014 Financial Reform. This reform includes, in the Stock Market Law[6], a transitory article that establishes that the *Nacional Financiera* (the Mexican Development Banking Institution, or "NAFINSA") must design and implement a scheme to encourage Investment Promotion Corporations to list themselves on the stock market.

A working group was formed for this purpose with representatives from NAFINSA, the *Secretaría de Hacienda y Crédito Público* (Ministry of Finance and Public Credit, or "SHCP"), the *Comisión Nacional Bancaria y de Valores* (National Banking and Securities Commission, or "CNBV"), the Mexican stock market and the Mexican Securities Industry Association (AMIB). This is the first time that a working group has been formed with both government authorities and investment institutions, and it was able to achieve many important advances during 2014, which are ready to be implemented in the first quarter of 2015.

As part of this process, the CNBV, together with the Mexican stock market, reviewed the general regulations applicable to issuing stocks and other investment tools, known as the Issuers' Unique Circular[7], on subjects such as positioning programs that will benefit a variety of different types of stocks, and aim to make the positioning process more efficient.

Additionally, to promote the positioning of medium-sized companies, a new category of public offers aiming at a certain type of investor has been created, establishing rules that issuers must comply with to make use of this category[8]. This was due to the particular characteristics of institutional and certified investors and their knowledge of the stock market, encouraging them to make investments in untested companies with a high potential growth rate.

Also, the authorities have considered loosening regulations for medium-sized companies. Details are expected to be finalized in the first quarter of 2015.

In addition to the modifications of stock exchange regulations, NAFINSA has designed a support program for medium-sized and large Mexican companies to modernize themselves and expand. This has the goal of strengthening their operations and supporting the process of institutionalization (implementing corporate governance practices) so that, within a period of three years or less, they will be able to issue debt or capital in the stock market. They can receive financing from anywhere between 300 million pesos to 1 billion pesos.

Among other requirements, companies must have annual sales in excess of 300 million

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6 *http://www.diputados.gob.mx/LeyesBiblio/pdf/LMV.pdf*

7 *http://www.dof.gob.mx/nota_detalle.php?codigo=5377392&fecha=26/12/2014*

8 *http://www.dof.gob.mx/nota_detalle.php?codigo=5378344&fecha=12/01/2015*

pesos, have a history of three years on the market and be caught up on their income tax payments in order to qualify for this program. They must also have a business plan and a corporate governance structure.

After meeting these general characteristics, financing in the first stage will be provided by NAFINSA. During the second stage, the company’s portfolio and its operation will be turned over to a Special Purpose Vehicle (English: SPV, Spanish: VPE). To the extent that the company meets the institutionalization requirements to be listed on the stock exchange (the first, second or third year), interest rates will be lowered to being only nominally higher than that of the debt issued.

As an incentive, the interest rate is therefore lowered in accordance with the company's credit rating and ability to meet the program's goals.

Another of the important actions taken by the Mexican Stock Exchange and AMIB has been to undertake a tour promoting financing on the stock market, titled “An Encounter to Grow.” Its goal was to inform medium-sized companies about the advantages of issuing debt. An important synergy was obtained between private consulting firms and investment firms, who used the tour to explain the tools and support programs that exist to help them. During the two months of the tour, 211 companies from every corner of the country were contacted.

Due to the success of this tour, the first of its kind, it will be repeated during the first quarter of 2015. The need to inform businesses of the advantages of financing themselves on the stock market is self-evident. These are efforts that are undertaken in other countries, sometimes using mass media.

Benefits

With the financial reform conducted in early 2014, further modifications were included to encourage medium-sized enterprises to list on the Mexican stock exchange (BMV).

In the Stock Market Law Reform, it was established within its transitory articles that NAFINSA shall design and implement a support scheme to encourage the listing of SAPIBs, this being a corporate structure that allows a transition period to fall in line with expected corporate governance practices, disclosure, etc., which was increased to 10 years.

Ten years is the amount of time permitted for SAPIBs to remain listed on the Mexican Stock Market before they have to become SABs - being that these issuers are listed on the main market and must adhere to all guidelines established by the LMV in terms of requirements, corporate governance practices, financial disclosure, etc.

In addition, and in order to achieve the objectives on the current government’s agendas, the need to encourage greater participation by medium-sized companies in the stock market has been established. The securities industry, together with the authorities, has been working on a project for easing registration requirements, listing, maintenance and disclosure in order to facilitate mid-sized businesses with carrying out listing process procedures for the Mexican stock market.

Among the changes to the regulatory framework, the ability to carry out public offerings of securities directed at a certain class of investors on the Mexican stock market has also been included, with requirements put in place for issuers to ensure its realization, which could permit, for example, institutional investors to participate in smaller placements, as is done in other markets where such activities are considered venture capital endeavors. This opens opportunities for funding for such companies that have great potential growth but require long-term investments to reach maturity.

An important aspect for mid-sized companies is that, based on modifications to the regulatory framework applicable to them to going public, they will be granted a period of three years (expires in January 2017) to continue using the accounting rules known as NIFs, and during the time that the regulations apply to them, implement a work plan and activities for transitioning to IFRS, allowing them to mature and bring themselves in line with international accounting rules without having to deal with onerous initial expenses.

It should be noted that, regarding the listing requirements, medium-sized enterprises shall be able to list on the Mexican Stock Exchange with an equity of 12 million UDIS (previously 15 million UDIS), which will allow smaller companies to access the capital market and, along with the new public offering option for targeted securities, therefore reduce the total number of shares.

In conclusion, there is great interest from the government, financial authorities and securities market participants in searching for mechanisms, establishing requirements and promoting flexible support programs offered by the Development Bank Institution and the Mexican stock market for listing new issuers, in order to allow mid-sized businesses to access capital through the BMV. Therefore, we believe that, by 2015, the market will offer more accessible financing for the development of major projects in various productive sectors (energy, telecommunications, infrastructure, real estate, commercial, etc.), thus enabling the securities market to position itself as an important source of financing and, overall, bring significant growth to the country.

Challenges

As we have already stated, the Mexican stock market is characterized by low participation from companies, which is unusual given the size of its economy. The government has therefore included a variety of strategies to promote the growth of the stock market in its 2014 financial reforms. Secondary regulations have already been issued that will ease the requirements for medium-sized companies that wish to list themselves on the stock market, but these regulatory measures have yet to have an effect.

There are 5 million companies in Mexico, of which 99.8% are micro, small- and medium-sized companies (INEGI, 2009). There are a total of 17,146 companies, reporting annual sales exceeding 30 million pesos. Approximately 7,000 of these companies generate 40% of Mexico's GDP and are considered to be medium-sized and large companies which have the size to be listed on the stock market.

The Mexican stock market and AMIB therefore have a great deal of interest in approaching these medium-sized and large companies and promoting the financial products available to them, such as the aforementioned support programs.

The great challenge for Mexico is to position the stock market as a real source of financing. To accomplish this, it is vital to approach the business community, teach them about the stock market and change the erroneous perception that the market is only for large companies.

Additionally, an alternate market is also being created for medium-sized companies which have lower capitalization but high growth potential, and which are looking to finance projects at a reasonable cost, as is the case in many other countries around the world.

It is also expected that all of the financial reforms will be implemented during 2015, allowing a greater number of companies to be listed on the Mexican stock market.

TAIWAN

Taiwan's financial system was gradually deregulated up until the mid-1980s. As a consequence of financial liberalization, internationalization and diversification, there have been significant structural changes in Taiwan's financial system. The ratio of bank-based financing dropped from 90% in 1990 to 71.5% in 2003. In contrast, during the same period, the ratio of direct financing from the capital market rose from 9.13% to 28.75%. This indicates that Taiwan is undergoing a significant transformation from a bank-based to market-based financial system.

Case Study: Launch of Go Incubation Board for Startup and Acceleration Firms

In order to provide active support for creative industries with developmental potential, the FSC on 5 December 2013 adopted the Program for Financial Support of Creative Industries, which seeks to help such firms obtain needed capital through bank financing, funding from insurers, and the Go Incubation Board for Startup and Acceleration Firms (GISA). The Small and Medium Enterprise Credit Guarantee Fund of Taiwan will raise guaranteed credit from 80% to 90% for creative industries. Also, the FSC is drawing up plans for education and training programs, and has established an advisory platform as well as a mechanism for the assessment of intangible assets.

The purpose for the establishment of GISA is supporting small-sized venture firms and paving the way for future economic and industrial development.

As of July 31, 2013, there are approximately 390,000 enterprises (64%) with paid-in capital between NT$ 1 million and NT$ 10 million, and 110,000 enterprises (18%) with paid-in capital between NT$ 10 million and NT$ 50 million in Taiwan. It is obvious that there are many small-sized venture firms with creative ideas and great potential. Although these companies may face difficulties with raising capital, the size of their companies, and obtaining proper assistance, it is worthwhile for them to grow and help further develop the industry.

With the support of Taiwan's competent authorities, the GTSM (Taiwan's second Board) started GISA in January 2014. GISA is designed to be a platform for small-sized, non-public venture companies, and to offer entrepreneurship counseling and capital raising functions (but not trading functions) to help venture firms acquire the needed capital.

GISA is characterized by its differentiated management and integrative counseling strategies that help small-sized venture firms grow, which in turn paves the way for future economic and industrial development, effective policies that promote economic growth, and the creation of mutually beneficial situations.

Characteristics

To enter the capital market, companies have to apply for retroactive handling of public offering procedures, have financial reports audited or reviewed by a CPA, establish internal control systems, and obtain internal control system reports from a CPA. However, the above-mentioned requirements may cause a burden to smaller venture firms.

GISA proactively helps small-sized venture firms in terms of establishing integrative counseling mechanisms to provide integrative accounting, internal control, marketing, and regulatory counseling services. In this way, non-public, small-sized venture firms are able to set up internal control and corporate governance systems.

GISA also helps non-public, small-sized venture firms raising capital at a lower cost. After being registered on GISA, small-sized venture firms will be able to enlarge their operating scale and increase publicity, which in turn will make it easier to recruit good talent, broaden sales channels, increase competitiveness, and maintain business sustainability.

Regulations[9]

The "Regulations Governing the Go Incubation Board for Startup and Acceleration Firms" are enacted for the purpose of counseling innovative and creative non-public enterprises of the Republic of China (ROC) on their development and assisting them with raising capital, in order to enhance the vitality and entrepreneurialism of the ROC's economy.

Benefits

The new GISA provides micro-enterprises with help raising funds. It will strengthen corporate innovation and value-adding. The FSC estimates that, with the establishment of GISA, 70 venture micro-enterprises will register in 2014 and raise an estimated total of NT$ 210 million.

Premier Jiang notes that Taiwan must increase the value of its industrial innovation if it is to strengthen the competitiveness of its economy, and that GISA will help by providing a good startup fundraising platform for venture micro-enterprises. Further, he goes on to say, the establishment of a public joint assistance mechanism will provide a full range of services to help enterprises grow and prosper.

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[9] For the full regulations, please check: http://eng.selaw.com.tw/FLAWDOC01.asp?lsid=FL072102

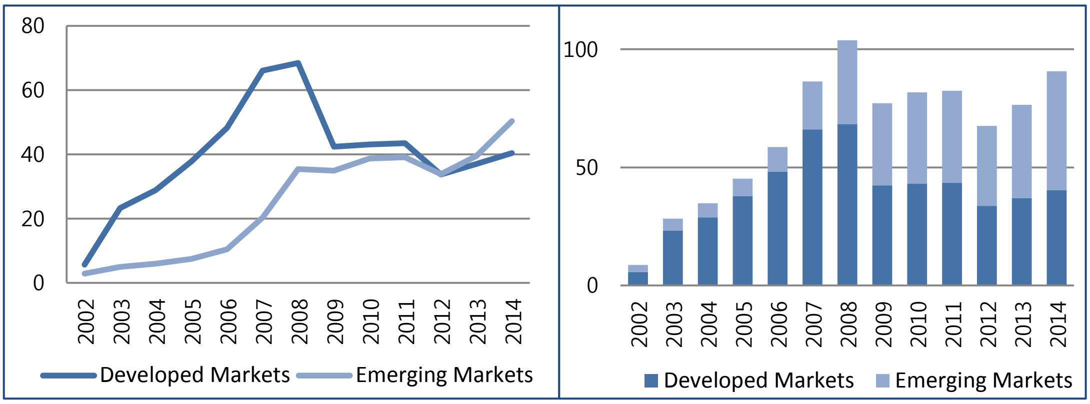
2. Analysis

According to the Financial Development Report by the World Economic Forum in 2012, other than Korea, which was ranked 15th, EMC economies were ranked between 32nd and 43rd out of 62 economies on the Financial Development Index. This means that EMC countries still have long way to go to advance their financial markets and corporate environment. On the other hand, the common belief that the financial intermediation of less developed countries or emerging market countries is dominated by banks is proven to be inaccurate in this paper.

Aside from Thailand and Turkey, the financial markets of the rest of the EMCs possessed stronger market-based financing characteristics, in some cases more so than in developed countries. This was achievable primarily due to the financial regulatory reforms within each EMC countries. After the global financial crisis, unlike advanced countries, which began to strengthen regulations in the direction of a market-based financial system and increasingly complex financial products, emerging markets have begun to open up and liberalize their markets by encouraging companies, especially SMEs, ventures and start-ups, to be listed on exchanges, and relaxing regulations that weigh down their efforts to raise capital.

Looking at the performance of global stock market, it is a fact that the value of share trading is decreasing globally. The financial crisis and European woes led investors to withdraw their investments from risky assets, and diminishing economic growth worldwide only exacerbated this trend. When looking at the value of share trading from a regional standpoint, however, it was observed that the value for emerging market countries has actually been increasing since 2008, with emerging markets surpassing developed countries in this regard in 2014.

<Value of Share Trading: Developed Markets[10] vs. Emerging Markets[11]



Source: World Federation of Exchanges

In addition, recent trends in the IPO market show a promising future for emerging markets as well. Since the 2000s, there has been a downward trend in global initial public offerings (IPO). The total number of IPOs and the value of funds raised were

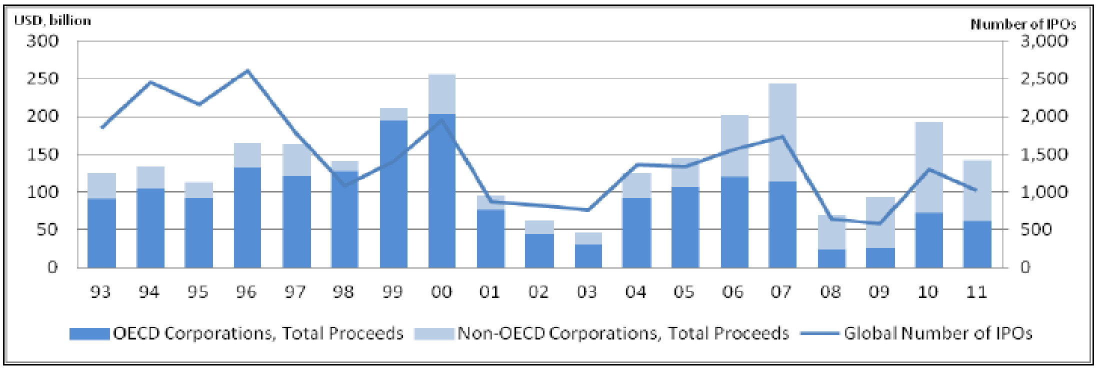
[10] US, Northern and Western European countries, Australia, Canada, Hong Kong, Japan

[11] Asian countries excepting Japan, Latin America countries, South Africa, Turkey

also on the decline. However, the figure also shows the dramatic change in the global IPO scene. Particularly driven by the US and UK markets, which traditionally have been the world's leading IPO markets, funds raised by OECD companies fell to half of the previous decade's average. At the same time, public offerings by companies in emerging countries increased more than five times and exceeded the total funds raised by OECD companies. (OECD, 2013)

< Global Initial Public Offering Trends>

Number of initial public offers and the amount of capital raised by non-financial corporations (in billions of 2011 USD)



Source: OECD calculations, based on data from Thomson Reuters, Datastream, and stock exchange and company websites.
Note: Data excludes investment funds, REITs, banks, insurance companies and other financial sector corporations. It covers a total number of 29.490 IPOs from 87 different countries.

Taking the full advantage of globalization, BRIC countries – Brazil, Russia, India, and China – and MINT countries – Mexico, Indonesia, Nigeria, and Turkey – became popular investment destinations for their prevailing populations and attractive rate of growth. Foreign investors poured their money into these countries in an effort to build a diversified equity portfolio. In 2012, foreign investors were the dominant shareholding groups in EMCs with the exception of India: foreign investors accounted for 35% of total market capitalization in Korea, 32% in Mexico, 66% in Turkey[12], 37% in Brazil, and around 10% in India[13].

"The cult of equity is dying." This was said by Bill Gross, CIO of PIMCO in August 2012. In May of the same year, the Financial Times defined the market situation as "the end of a six-decade passion for equities." Interestingly, these comments would only apply to advanced countries, because emerging market countries showed exceptional performance even after the financial crisis in 2008.

The data and cases given above reveal that market-based financing is well-entrenched in emerging market countries. It can be confirmed that there is an inevitable trend in emerging markets toward expansion of non-bank, marketable securities mechanisms for providing credit as their capital markets and institutions mature, a trend which will continue.[14]

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[12] 2014 data was used for Turkey and Korea and 2010 data was used for India.

[13] The calculation for foreign investors' shares in Mexico is quoted from Reuters. Calculations for India and Brazil are quoted from Bloomberg.

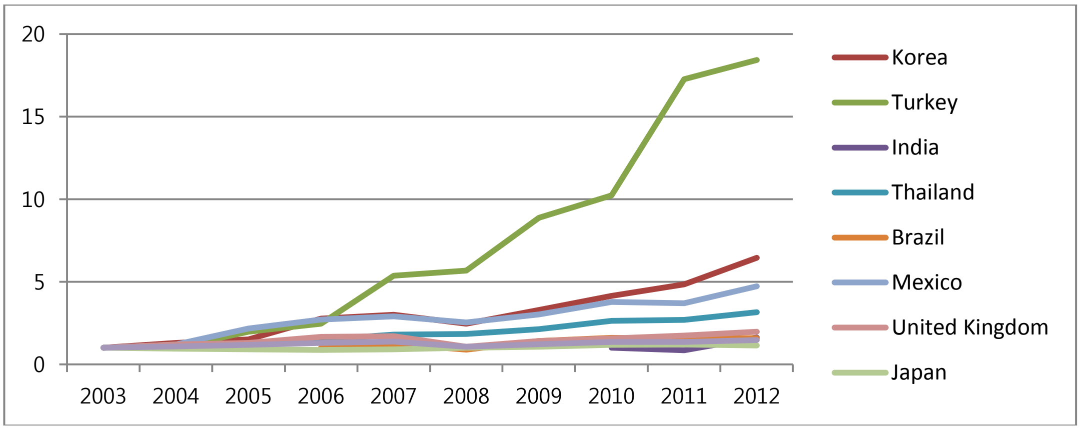
[14] Spence, A. Michael. Emerging Financial Markets after the Global Financial Crisis.

3. Opportunities and Challenges

Emerging market countries' implementation of a market-based system will likely continue, given the favorable macroeconomic and market situation. Corporates in advanced countries are projected to decrease the size of their investments due to the decline in the growth rate. The slowdown in economic growth, coupled with the drawn-out impact of the global financial crisis, is expected to influence demand for capital from these corporates, thereby causing a depression in raising capital. On the contrary, emerging markets are projected to show an increase in investment size backed by positive forecasts on their growth rates, which, in turn, leads to demand in capital by corporates in these markets.

Another major opportunity is the pension reforms. Emerging market countries have endorsed pension reforms rather late compared to advanced countries. In Turkey's case, through the pension reforms that took place at the beginning of 2013, the number of investors has increased in the last two years, from 3 million to around 5 million, while the growth in the size of the portfolio has been more moderate, reaching almost $15 million in 2014. In the case of Korea, the Retirement Pension Plan was introduced in 2005 and, since then, the pension market has grown to become worth approximately $100 billion, a 100-fold increase compared to its $0.8 billion size when first introduced.

<Growth Rate of Pension Funds in EMCs and Selected Developed Countries>

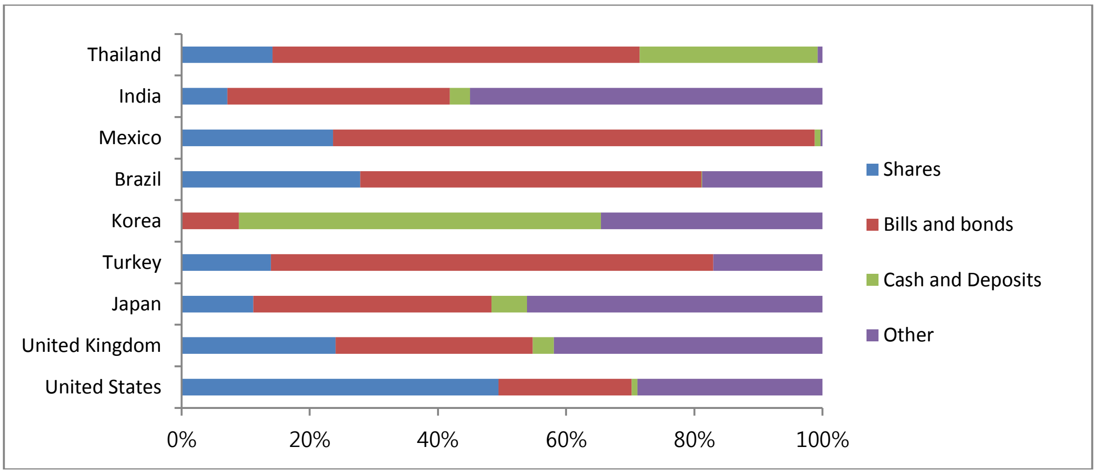


Source: OECD Stats

In terms of the absolute amount, emerging markets cannot compete with developed countries, but the rate of growth is impressive nonetheless. Emerging markets, in particular Turkey, Korea, Mexico, and Thailand, have shown a significant increase in the growth rate of total investments in pension funds. In most emerging market countries, with the exception of Korea and India, the amount of capital invested in pension funds directly flowed into the capital market, as illustrated in the graph below, creating a virtuous cycle between the capital market and the economy as a whole of growth. As a result, as their capital markets continue to rapidly grow, the financial systems in emerging market countries will shift toward a more market-based system.

(http://media.pimco.com/Documents/Emerging%20Financial%20Markets%20Spence_US.pdf)

<Pension Fund Allocation for EMCs and Selected Developed Countries, 2013>



Source: OECD Stats

Despite the favorable outlook and potential opportunities, emerging markets must still carefully manage the development of their capital markets. In emerging economies, market values tend to improperly reflect the intrinsic value of the corporates, and stock market speculation can easily occur, thereby increasing market volatility and ultimately having a negative impact on market integrity. Furthermore, corporates' long-term investments for enhancing productivity will be constrained if the market becomes too volatile. Under such a scenario, emerging markets with a market-based financing system may not be able to achieve economic growth and stability in the same vein as with a bank-based system.

To avoid this, emerging markets must take actions to advance their financial literacy and market sophistication. One way of increasing financial literacy is by educating both investors and industry professionals. In the wake of the recent global financial crisis, financial education is being increasingly emphasized worldwide. Financial education is one of the most effective tools to improve the financial literacy of individuals and help prevent financial crises.

From a micro perspective, financial literacy is beneficial to the welfare of individual investors. From a macro perspective, it ultimately contributes to the development of the market and economy. There is no doubt that sound and comprehensive financial education programs, norms and practices are critical to ensuring the stability and vitality of capital markets.

Promoting market sophistication is another key element to overcoming these difficulties and promoting the healthy development of emerging markets. Market sophistication refers to the establishment of new financial products, and the continued liberalization of the financial system. To this end, emerging market countries will need to continue to support and cultivate the ongoing trend of market-based finance in their regions, as well as endeavor to remove redundant or excessive regulations that hinder sustainable growth in their markets. However, it must be noted that, as was witnessed during the global financial crisis, the unrestrained deregulation of financial markets can lead to market instability and systemic failure. Indeed, the UN asserted that financial deregulation, driven by an ideological belief in the virtues of the market, was responsible for the innovation of financial instruments that were completely detached from any productive activities in the real economy.

The global crisis, and the role played by developed countries in the events that led up to it, provide emerging market countries with a valuable opportunity to take the necessary steps to avoid following the same path. This can be achieved through "smart regulation," which is described as setting a sufficient level of regulation, such that market integrity is maintained, while simultaneously nurturing market innovation. However, this creates its own challenge, as each emerging market country is faced with its own unique variables that need to be taken into consideration. As such, one possible solution would be the formation of a coalition by the EMCs, with the purpose being to research and study the appropriate level of regulation for different countries based on their particular economic characteristics, such as current growth rate, expected growth, geographical factors that impact the economy, and so on. Another possibility would be ICSA's EMC and IOSCO's GEM committee working together to conduct an empirical study on this topic.

In conclusion, as has been indicated by a number of studies, market based-financing is deemed more effective at spurring economic growth after a nation's economy has surpassed a particular level of development. In this paper, as well, it is also found to be true that, as their economies develop, EMC countries are increasingly shifting toward the market-based financial system. These countries should therefore continue efforts to endorse their capital markets to be more efficient and progressive, while also taking economic growth into account.

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