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Credit Rating Services in Nepal: An Assessment Report

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PREFACE

The following document was prepared for the Institutional Reform and the Informal Sector (IRIS) in Nepal, funded by the U.S. Agency for International Development. Field work for the study was carried out between June 20 and July 6, 1994. During this time more than 25 interviews were conducted, including the National Planning Commission, government officials, the Nepal Rastra Bank, the Securitics Board, the Nepal Stock Exchange, commercial banks, financial intermediaries, international donors, and private sector companies. An outline of the recommendations was prepared in the field and discussed representatives from USAID-Nepal, the National Planning Commission, the Nepal Rastra Bank and IRIS Nepal.

The consultant wishes to express her appreciation to all the people interviewed and other people whose collaborated with the study. Specifically, gratitude for assistance with the study is extended to Praveen Dixit, Director of IRIS-Nepal, Anita Tuladhar, PDC Director of the Economic Liberalization Project, and Anuja Rajbhandary whose diligence and insights made a substantial contribution to this study. The final conclusions and recommendariuns presented in this report are the sole responsibility of the consultant. It is hoped that this report will provide a sound basis for developing a credit rating agency in Nepal, and encourage the development of a sound and efficient financial market.

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I. INTRODUCTION AND BACKGROUND

Nepal is an economy in transition. Since the conversion to a constitutional democracy in 1991, economic reform and liberalization efforts have been undertaken in many sectors, particularly with respect to trade and industrial policies. Emphasis has been placed on private sector development and a market-oriented economy. His Majesty's Service (the government) is now in the process of reforming the tax system and the financial sector.

Although a Securities Exchange Centre (SEC) was established in 1976, primarily trading in government bonds, it was not until 1983 that a secondary market was permitted to operate under the Securities Exchange Act. The SEC functioned as both stock exchange and regulatory agency until 1993, when a separate Securities Board was created. The reformed Nepal Stock Exchange (NEPSE), which officially opened in January 1993, was given the responsibility for trading activities, while the Securities Board was authorized to perform regulatory and compliance functions. Currently, the new Nepal Stock Exchange is experiencing phenomenal growth with new share issues commonly oversubscribed by as much as 60%.

Financial sector reform has also resulted in the establishment of seven joint-venture banks and two government owned banks, one of which will likely be privatized in 1995. New legislation has permitted the creation of private finance companies, leasing companies. venture-capital firms, and insurance companies. The high levels of defaults on bank loans continue to rise; and new provisions for loan recovery are being considered with a view towards achieving the internationally accepted "Bank for International Standards" (BIS) capital adequacy ratios. It is feared that loan defaulters can readily access other credit or capital through new, inexperienced financial institutions and highly liquid banks, as well as the capital markets, to raise equity.

This burst of new financial sector activities has left the government and the authorities ill-prepared to cope with the situation. There is a need to establish an appropriate regulatory and legal framework and. more importantly. to establish mechanisms for enforcing existing regulations. Lack of experience and inadequate information on the part of corporate management, bankers, debt and equity issuers, financial intermediaries, regulators and government officials have led to a distorted financial market. Availability of, and access to, information on publicly traded companies is seriously lacking, while issuers are often negligent or even evade compliance with reporting requirements, In certain cases the true identity or background of the promoters or sponsors is not fully disclosed. Some companies traded on the stock exchange have not filed financial statements for the past two or three years, and often statements are unaudited or completely unreliable. The investing public is thus left with little more than rumors and speculation with which to make investment decisions. This situation has caused great concern within government, as well as the financial and business communities.

To address these concerns, particularly with the aim of protecting the newly emerging financial sector as well the investors, the Nepal Rastra Bank along with the National Planning Commission contemplated the establishment of a Credit Rating Agency. One option was to integrate the rating agency into the existing Credit Information Bureau, which collects information on bank loans and defaulters. Another option was the creation of a separate entity to perform rating services only. In either case, the rating function was to be under the auspices of the Nepal Rastra Bank. A fact-finding study was undertaken from 20 June to 6 July, 1994 to assess the situation in Nepal and to recommend a regulatory and operational framework for a credit rating agency.

In the course of interviewing approximately 25 bankers, financial intermediaries, capital markets and government authorities (Annex A), it became apparent that there is a general misconception of the role and function of credit rating agencies. Accordingly, one of the principal tasks undertaken during the two-week period was to introduce the basic principles underlying credit rating agencies and the rating process. This was done in informal sessions during interviews and at a formal presentation to the Federation of Nepal Chambers of Commerce and Industry. Section II is an amplification of these discussions.

Although this study may appear to have been premature, given the nascent state of capital markets in Nepal today, it is important to have a long-term perspective. Adequate lead-time is necessary to create a viable and credible institution. Training a professional and qualified staff of analysts can take 1 to 2 years. Developing relationships with corporations, financial intermediaries and other participants, based on professionalism, experience and trust requires sufficient time and effort. Moreover, there is at present a sense of urgency which necessitates a proper and thorough understanding of the role and function of credit rating agencies. This urgency stems from at least one application received by Nepal Rastra to approve the establishment of a credit rating agency. Under the existing Central Bank Act, there is no provision for either the establishment of a rating agency or for the authorization of one by the NRB. NRB is thus contemplating seeking an approval from Parliament to amend the Act. But perhaps most significant is the applicants' limited knowledge of the functions and responsibilities of credit rating agencies, as demonstrated during an interview. If such sponsors are permitted to proceed without the proper guidance, procedures, or skills the whole rating process could be jeopardized, leading to serious problems for investors and turmoil in Nepal's capital markets.

It is therefore strongly recommended that a decision regarding any pending applications to establish a credit rating agency in Nepal be postponed, until the information contained in this report is reviewed, and implications fully discussed by all parties concerned.

II. WHAT IS A CREDIT RATING AGENCY?

In response to the growing volume of cross-border investments, the growth of new, expanded capital markets combined with an expanding universe of debt/equity issuers, credit rating agencies are increasingly viewed as an important link in the evolving financial market process. They provide a rating system that is designed to be accurate, reliable, and globally consistent. Modalities for rating agencies, while to some extent regional or local in scope, are becoming more universally accepted with the globalization of the financial and capital markets. The criteria and guidelines presented below reflect those modality considerations.

A. Context

The best-known credit rating agencies are Standard & Poor's Corporation and Moody's and to a lesser extent Duff & Phelps Inc. and Fitch Investor Services. Additionally, Keefe, Bruyette & Woods and International Bank Credit Agency specialize in rating the domestic and international banking sector. Some of the more established agencies, operating for over 50 years in the United States, have now begun expanding overseas. Moody's, for example, founded in 1909 first introduced a securities rating system to rate U.S. railroad securities; it now has 6 offices overseas. More recently, other countries have authorized the establishment of credit rating agencies or services, including: Sweden, France, Japan, Australia, Hong Kong, India, South Korea, the Philippines, Israel, Mexico and Chile.

Not all credit rating agencies operate in the same manner and much depends on prevailing local regulations and market conditions. For example, in some countries rating agencies are partially or fully owned by a government entity such as a central bank. In mast other countries, they are privately owned and under the supervision of a regulatory authority, usually the securities exchange board. Some countries have introduced mandatory rating requirements, which has not always been met with favorable results. Notably in Japan, ratings are given on issues even though the issuer has not commissioned them. Such an imposition can antagonize the issuer, and rather than cooperating with the rating agency, the issuer can withhold key information that could distort the analysis and thus the rating. On the other hand, some countries which have initiated mandatory rating requirements (e.g. Mexico) use a less forceful means; they simply prevent a debt security from being sold in the public markets unless it obtains a rating.

B. Function of Credit Rating Agencies

A credit rating agency is an independent, professional organization that analyzes the repayment risk of debt instruments which include bonds, debentures, preference shares, commercial paper, certificates of deposit, fixed deposits. The agency must be independent in order to establish objective, impartial, and trustworthy analysis of debt-risk classifications, known as ratings. A credit rating is essentially a tool for capital market participation by both issuers and investors, providing an opinion regarding the financial ability and legal obligation of an issuer to make timely payments of principal and interest (or preferred dividends in the case of preference shares) on a debt security over the life of the instrument.

A rating system provides predictive information on default risk for use by investors, who must be willing to accept risk on any investment they make. Ratings guide investors in determining the level of credit risk associated with each debt security, and offer the investor a quick and efficient means of obtaining information needed to make an informed investment decision. Accordingly, ratings are typically released before the issue goes to market.

Once an issue has been rated and placed in the public markets, it is the rating agency's responsibility to ensure the accuracy of the rating over the life of the debt instrument. This requires continuous monitoring of the financial condition of the issuer. Ratings are typically reviewed at least once each quarter (4 months). In the event the financial condition of the issuer changes, either improves or deteriorates, the rating of an issue could be upgraded or downgraded accordingly. Ratings my be changed, suspended or withdrawn, but the agency must announce this to the public and explain both the criteria and rationale for doing so. Issuers comprise corporations, government (national, state, local), banks, insurance companies, finance companies, supranational agencies and development banks (the World Bank), public utilities, etc.

Credit rating agencies do not rate common equity, bank loans, issuers or borrowers. Nor do they make recommendations on whether to buy, sell, or hold shares or rated debt instruments, or guarantee repayment of a debt instrument.

C. Basic Principles which Guide Credit Rating Agencies

The basic principles which guide credit rating agencies can be summed up in terms of trust and confidence which underlie the rating process. A rating agency must avoid any actual or potential conflicts of interest. Its relationship with the entire financial services industry (issuers, investors, financial intermediaries, government, regulators, insurers) must be strictly arms-length. A rating agency's management, board, staff or any members of their households may not hold shares or represent the companies in which they participate in the rating decision. Under no circumstances should any outside compensation or other benefits be accepted by these parties in connection with employment at the rating agency. Fees collected by the rating agency for the services performed is under contractual terms and conditions and for the account of the agency only. Further. all employees of a credit rating agency (staff, management, and board) must be prohibited from being engaged in the selling or trading of securities.

Rating agencies will typically also have internal control policies, closely reflecting those of the securities industry, regarding insider trading. This is defined as any transaction that is based on material inside (i.e. non-public) information, which could be used to buy and sell securities. Such information remains outside the public domain for specified periods, depending on regulations set forth by the securities board authorities. Confidential information must not be disclosed to anyone who is not authorized to know it as part of the rating process. Such information must not be disclosed to investors, other issuers, or any other unauthorized parties. Disclosure is the duty of the issuer. For instance, in the event the issuer decides not to use the rating obtained from the rating agency, the agency is prohibited from making that information public or from informing anyone who is not authorized to know this. In announcing a rating or any modifications, the agency is compelled to **disclose** both the criteria it used to arrive at the rating as well as the rationale for the rating.

A compliance unit within a credit rating agency is responsible for overseeing full compliance with pronounced standards and procedures. Offenders are penalized, dismissed, or criminally charged.

In brief, procedures used by credit rating agencies are driven by the need to:

* establish credibility of the rating agency and the rating process;
* develop and maintain rules of confidentiality;
* establish and enforce rules of full and accurate disclosure by the issuers;
* ensure integrity of analysis undertaken for each rating;
* provide broad dissemination of ratings and opinions issued by the rating agency.

D. Criteria for Determining Credit Ratings

The primary characteristic for determining a debt rating is based on an assessment of the credit worthiness of the issuer with respect to a specific issue. Ratings are based on several considerations: 1) likelihood of default; 2) nature of and provision of the debt instruments; and 3) relative position and protection of the debt instrument in the event of bankruptcy or other circumstances of default by the issuer.

A ratings methodology is based on an assessment of the risk associated with receiving timely payments on principal and interest on a given debt security, and how this risk compares to that of other debt securities (including preference shares which are a form of hybrid security). It requires well trained and qualified analysts who arrive at their conclusions through an analysis of various factors and considerations:

* Qualitative and quantitative analysis, including the issuer's ability to generate cash, and determining the predictability of future cash generation by the issuer, by means of a thorough analysis of the Issuer's historical annual reports and financial statements;

* Special features of the issue, such as maturity of the issue, the interest rate, convertibility features, etc;

* The relationship of one issue to other obligations of the issuer, such as outstanding bank debt, subordinated debt, and other publicly issued debt securities:

* Operating performance of the issuer, guarantors (e.g. bank or other company or government agency), insurers, or lessees;

* Appropnate financial ratios for the issuer's industry or sector, and issuer's own operating historical ratios;

* Economic and political environment, industry characteristics including market demand, market share and competitive position of the issuer, quality of management, issuer's strategic direction, technology, outstanding legal issues, and government regulations.

E. Rating Symbols

A key characteristic of any credit rating system is that each rating symbol is applied universally by the rating agency so that the same meaning and interpretation is available to all the issues that are evaluated. Thus, the same rating symbol will apply to an issue regardless of the currency of the issue. the type of issuer (i.e. bank, utilities company), or the issuer's country of origin. This ensures consist and comparable evaluation.

Although there is no one universal set of symbols used by all the rating agencies. rating agencies do classify issues in basically the same way, utilizing a descending system of numbers and/or letters. Ratings also distinguish between short term and medium- and long-term debt instruments. A general classification system, following the one originally developed by John Moody for long-term ratings, is utilized in many countries. It is outlined in Appendix B.

F. Fees

Fees for obtaining a rating are paid to a credit rating agency by the issuer. Many in the credit rating business would prefer that investors pav for the rating, since it is a service to the investor. However, this has been difficult to achieve. Fees are commonly charged on the total amount of an issue, in amounts ranging between 1.5 % to 2 %, or a flat annual fee is negotiated with the issuer, entitling them to unlimited ratings for the year. Some agencies charge an issue fee of .10%, plus an annual surveillance fee, plus out of' pocket expenses for producing the rating.

III. THE PRESENT SITUATION IN NEPAL

As noted in the introduction above, there is substantial concern in Nepal that the entire financial sector has the potential to experience substantial losses unless certain actions are taken to place controls and disciplines on the various participants -- issuers. investors, banks. and financial intermediaries. Since protection of public investors is of paramount importance in the capital markets environment, it was supposed that a credit rating agency would serve a watchdog function that would control loan defaulters as well as issuers and promoters, by eliciting and making public their track records and the operating performances of their companies. The existing Credit Information Bureau was envisioned as possibly forming the basis for a rating agency, by either incorporating it into CIB, or by creating a related institution; in either case, under the auspices of the Nepal Rastra Bank. With this in mind, NRB has consider& granting guarantees on each rating, and having approval authority over which companies could issue securities. This course of action would expose NRB to massive contingent liabilities in the event that an issue covered by a guaranteed rating defaulted and the investors laid claim to the guarantee. Notwithstanding such considerations, it is within the scope of the Securities Board, not NRB, to approve the issuance and listing of securities.

This study has attempted to demonstrate that a rating agency cannot, in fact. alleviate all the concerns confronting the financial sector and investors. The scope and function of credit rating agencies is limited and specific. By their very nature, credit rating agencies do not rate bank loans or the borrowers nor companies (issuers) or their common equity. They rate debt instruments that are issued through the capital markets. The function of the Credit Information Bureau in Nepal is twofold, one is to track information on loans and the other on defaulters. It is important to recognize these distinctions -- one pertaining to the capital markets and the other to the banking sector. In the opinion of this consultant, an attempt to combine these distinct functions would obscure the true purpose of each respective function. There are inherent risks in every investment. To mitigate some of the inherent in each investment, institutional strengthening, improved regulations and disclosure requirements, supervision and monitoring must be instituted. An of course, enforcement procedures need to be both adequate and earnest.

The activities of the Credit Information Bureau and the securities market in Nepai are highlighted below, as these provide the framework for the resulting recommendations.

A. **The Credit Information Bureau**

The Credit Information Bureau (CIB) was established in 1989, under the control of the Nepal Bankers Association (NBA), following the recommendations of the World Bank, as part of Nepal's financial sector reform program. CIBs stated principal objectives are "to collect information on borrowers from its member institutions, analyze and exchange it in order to facilitate the assessment of credit risk so that proper end use of funds are ensured and unhealthy credit transactions are controlled". The information is made available to the member banks, of which there are nine commercial banks (including 7 joint-ventures), the Agricultural Development Bank, and the Nepal Industrial Development Corporation. In fact, CIB performs these functions more or less successfully in view of the constraints it faces -- inadequately trained staff and an inefficient computerized information system. A study to assess CIB's capabilities was undertaken in February 1994 by Lintasarta, an Indonesian consulting firm, which recommended among other things strengthening the database system and the telecommunications network.

CIB collects, maintains and disseminates information on: 1 j non-defaulted loans exceeding NRs 2 million; 2) defaulted loans which are 6 months past due and ranging between NRs 500,000 and 2 million; and 3) the "blacklist" of borrowers with past due loans in excess of NRs 2 million. The blacklist is circulated to all NBA member institutions. Removal from this list is conducted under terms agreed to by the NBA and Nepal Rastra Bank (NRB), which stipulate that no member institution is permitted to extend a loan or other credit facility to a borrower on the blacklist until the borrower is withdrawn from the list by CIB. Repayment of the defaulted loan appears to be the. only way (with the possible exception of the borrower's demise) a defaulter is removed trom the blacklist. With the banks prohibited from lending to blacklisted borrowers, and loan restructuring initiatives still in the planning stages, the blacklisted borrowers' inability to access other credit lines is tantamount to foreclosure.

While the banks acknowledge that they are grateful to have this information, they are also concerned about its free flow. It appears that the entire blacklist is circulated to member institutions on a regular basis with little or no regard to or supervision over the confidential nature of the information. Conceivably, if this information got into the wrong hands (i.e. unauthorized person in the member institution) it could be used for illicit purposes. This may explain the reluctance by some of the banks to comply with the directives of the NRB, which require that each member institution "supply the information solicited by the CIB" and that failure to do so is a violation of the NRB Act of 1955. According to the CIB and the NRB, the member response rate is only 55%-60% of the more than 2500 loans in CIB's database. Another reason offered for the low response is that the CIB, while set up by the NRB, is actually under the control of the NBA but headed up by a senior officer of the NRB. Without the clear backing of the NRB, CIB has little recourse to the member institutions who do not submit the information. CIB is only authorized to send out a letter to the member institution requesting the information on loans and borrowers. Compliance is not mandatory on the part of the member institutions and no penalty is imposed for non-compliance. No provision in the Central Bank Act dictates that information be provided to the NRB, or penalizes for non-compliance.

Lacking both the authority and influence to enforce under its mandate, CIB's management is seeking other means to be more actively engaged. One area in which CIB would like to expand its scope is in loan analysis to determine whether the defaulted and blacklisted loans are properly "guided". Although examination of defaulted loans is under the purview of the Inspection and Supervision Department of the NRB, audits primarily conducted mainly on the larger banks, and enforcement of banking regulations are apparently relatively lax. Classification of loans is done by the banks themselves. in accordance with the guidelines established by NRB, and reviewed annually by NRB auditors. It is uncertain whether reserves for bad loans and charge-offs are strictly enforced, and as this was not the scope of this study (time was limited), claims to that affect were not investigated further. However, what is clear is that CIB's mandatc docs not call for it to bc involved in loan analysis. Instead, CIB should concentrate on collection and dissemination of information, expanding into production of statistical reports on loan demand by sector or industry, etc. A more detailed proposal for restructuring and strengthening CIB is presented in Section IV of this report.

B. The Nepal Stock Exchange

The Nepal Stock Exchange (NEPSE) is owned by Nepal Rastra Bank (48%), the Ministry of Finance and the Ministry of Industry (40%), and the Nepal Industrial Development Corporation (12%). Sixty-six companies are presently listed on the Exchange, although only 18 are actively traded. Since the new Nepal Stock Exchange opened in January 1994, as the successor to the Securities Exchange Centre, only 3 new companies have been listed. Yet, in the first six months of this year market capitalization has risen 200%, tripling in less than one year to NRs 12.1 bn (US$ 246m). Daily turnover is NRs 2.5m (US$ 51 ,000), averaging 50 to 60 transactions. It is not unusual for new issues to be oversubscribed by 20 times the issued amount. There are 25 licensed brokers who deal in the secondary market, trading both listed and unlisted shares, and 5 market-makers. A fairly active private placements market (i.e. unlisted issues) is also underway, but it was difficult to ascertain its size.

A monthly bulletin produced by NEPSE provides updated information on trading trends of the most active sectors and companies. But does not produce a fact sheet on listed companies on a regular basis. Of the 66 listed companies nearly 50% are in the financial sector (hanks, insurance companies). Only the actively traded companies are published in the daily newspapers. Trading is done on the 'open auction principle' on the trading floor, using a manual board. It is restricted to listed corporate securities and government bonds, although the latter have not been traded since the start of the new stock exchange due to the prohibition by the Nepal Rastra Bank to allow a full secondary market in government bonds.

Criteria for listing include the requirement that a public company must have at least 100 shareholders, 15% of total capital must be distributed to small shareholders (who hold up to 100 shares), the par value is NRs 100 per share, and 3 years of audited financial statements must be submitted. Some companies have 10,000 to 20,000 shareholders. To protect the small investor, the Nepal Shareholders Association, a non-governmental organization, was formed in January 1992 by 10 founding members. The Association acts as a watchdog office by participating in annual general meetings of the publicly traded companies and "interprets" companies' financial statements to shareholders. In the event of oversubscription, the Association takes on a mediator's role to ensure broad distribution of shares, and notifies the regulatory authorities and government ministries of dubious company actions and trading practices.

C. The Securities Board

The Securities Board was established in January, 1994 as an autonomous corporate body to oversee the functions of the stock exchange and to ensure compliance with regulations. Its functions relate only to capital markets activities, specifically aimed at ensuring that the Nepal Stock Exchange operates in conformity with the rules established. The Board's mandate includes regulations over issuance of new securities. The amended Securities Exchange Act of 1993 requires that companies offering their securities to the public must register the securities with the Securities Board and are required to submit a prospectus for each new issue. The prospectus contains relevant information about the issue, qualifications and composition of the Board of Directors, company management and financial statements. For every new issue, an announcement is published in the local newspapers which states the issue price, whom to contact and the minimum number of shares to be subscribed. Listed companies are required to submit financial statements semi-annually.

The Securities Board is in the process of developing specific rules approval of all listings now being done by the Nepal Stock Exchange. It will also be responsible for approving all new issues and issuers, as well as securities registration. A study of the Nepal capital markets, prepared in 1993 by the Aries Group, Ltd for the Asian Development Bank, came up with a set of practical recommendations for the Securities Board. Inded in the recommendations are the authority to formulate disclosure rules, accounting rules, and a supervisory and monitoring role over capital markets financial intermediaries.

D. Supply and Demand Considerations

The availability of different types of securities was originally envisioned by the Securities Exchange Act (1993) as well as the Company Act, Securities are defined as: stocks, preference shares, bonds, debentures, debenture stock, certificates relating to a unit trust scheme or group savings scheme, and treasury bonds, In practice, few securities (common equity and preference shares) can now be issued, due to either limitations imposed under certain provisions. or the complete absence of any kind of provisions that would permit the listing of such securities. The Company Act, for example, does not define the basis on which companies can issue securities, except to state that payment of dividends on preference shares takes priority over ordinaryicommon shares. Nor does the Act define the rights or obligations of the issuer or the holder.

Certificates of Deposit and Fixed Deposits are also included under the definition of securities, but no provision exists for listing such instruments on NEPSE. An act of Parliament would be required to do so. While the Securities Exchange Act permits NEPSE to list common equity, preferred shares, and debentures, the Company Act prohibits debentures from being listed unless they are in the name of the debenture-holder. In addition, the Company Act authorizes the issuance of unsecured debentures in the amount of 50% of total paid-in capital, although there is no provision in any of the Acts for the existence of a trustee who would be obligated to exercise certain rights on behalf of the debenture-holders. Only the commercial banks are authorized to act as trustees, but they have shown no inclination to do so. thus restricting the issuance of debentures. Further hindering the ability of companies to issue debentures is the fact that NEPSE does not encourage the issuance of such instruments as they are perceived to be "too risky". According to NEPSE, fixed income securities are not popular in Nepal because *the coupon rates are perceived* to be *too* low *for the* perceived risk. Indeed, they would have to be priced substantially above the current 9% rate on bank deposits, and possibly be offered as convertible debentures, or secured by fixed assets. Thus, very few debentures have thus been issued. But demand for debt securities may increase as the *on-going* privatization of the 60 state-owned companies is expected to generate a greater need for financing, which the commercial banks may be unwilling or unable to supply. For example, one company scheduled for privatization is contemplating a NRs 70 million initial public offering in the form equity (NRs 30 million) and convertible debentures (NRs 40 million). Convertible debentures in the current market are relatively attractive due to expected upside potential of the equities market.

There also appears to be a growing demand for preference shares. although these are often executed as unlisted private placements **and** are therefore less subject to scrutiny by the Securities Board. Previously, the *Securities Exchange Centre* **approved the** issuance of debentures and preferred shares for Jyotti Spinning Mills, Bottler's Nepal, and NECON Air Ltd. In the case of Jyotti, the 8-year issue paying a 19% dividend was comparable at the time to hank lending rates and was substantially undersubscribed, raising only NRs 9 million of a total NRs 50 million. It is now trading on the secondary marker at slightly above par value. The Bottler's issue was **only** able to raise NRs 5 million at an 18% dividend rate. More recently, NECON raised NRs 24 million, half of which was equity and the other preferred shares with sinking fund provisions. A preference share offering is currently underway for Birat Shoe Company Ltd. The shares will be listed on NEPSE, and paying a dividend of 18% (significantly above the current bank rates}. It will be interesting to see the subscription results, as this may herald greater demand for fixed-income instruments.

Today, few public debt *instruments are available to the investing public.* Government securities (Treasury Bills, Notes/Bonds) are issued by the Nepal Rastra Bank, with maturities of 91 days to 1 year, and purchased by commercial banks at weekly auctions. Members of the stock exchange and the public are prohibited from participating in these auctions *and no secondary market* exirts. *National* Savings Certificates (NSC) issued by the government had been offered in 5 and 10 year maturities and were lax-free. but not fully negotiable. The 5-year NSCs were offered to individuals, and 10 year NSCs were sold to nonbank financial institutions (banks could only buy them on the secondary market}. But the government has suspended *the issuance* of NSCs in an attempt to reduce the budget deficit.

From the demand side, long term. fixed-income investment capital is typically sought out by pension plans, insurance companies and provident funds. High quality, non-Governmental debt instruments are attractive mechanisms for these types of investors. In Nepal.

though, a Pension Fund Law has not been enacted and debt securities are essentially limited to government bonds. Two savings mobilization schemes have been created as provident funds for government and private sector employees: also several insurance companies provide policy-holders with savings accumulation opportunities.

1) The Employees Provident Fund, established in 1963 pursuant to an Act of Parliament, is managed by an Administrator with a Board of Directors and under the auspices of the Ministry of Finance. Total funds currently under management are NRs 6bn with approximately NRs 1bn added annually. The Fund was created as a savings mechanism for government employees who are obligated to contribute 10% of their salary which is deducted from their paycheck and matched equally by the government. Non-governmental employees can also participate, but on a voluntary basis. The Fund has adopted strict investment guidelines. enabling it to invest only in government bonds, fixed deposits and cash certificates, loans which carry government guarantees, housing schemes, and consortium financing. It can also invest in corporate debentures, but only for housing projects, under government guarantee, and also in shares of banks and financial institutions provided that such investment does not exceed 25% of the issued capital of the institution. Given the limited amount of investment possibilities, most of the portfolio has been invested in government Bonds and bank time deposits, and has had 13% annual returns. Unfortunately, with declining interest rates such returns are much more difficult to achieve.

2) Employees Savings Growth Scheme, operated by the Citizens Investment Fund, is a mutual savings scheme launched in 1992 to enable government and company employees to participate in a 5% voluntary withholding from their monthly paycheck. This 5-year open-ended "mutual fund" invests in government and corporate (10% of' total portfolio) securities, and has posted an annual 15% return on investment and principal is guaranteed. It currently has 30,000 participants, with total assets of approximatcly NRs 2 1 million. Established in 1990 under the Citizen Investment Trust Act, at the initiative of the Securities Exchange Centre, the Fund is managed separately from any other CIT equity funds. CIT's shareholders include the NRB (40%), banks and financial institutions (20%). and general public (20%). The g-member board includes representatives from the shareholder group as well as outside experts. Besides savings mobilization schemes, CIT is also engaged in investments (corporate shares and financing (term loans, bridge finance), and capital markers services (underwriting, brokering, market-making, and consultancy services). CIT is planning to launch a "unit trust" scheme for participation by all citizens, with a portfolio mix more heavily weighted in corporate securities (approximately 40% of portfolio) and with tax-free dividends.

3) Insurance companies are governed by the Insurance Act and under the supervision of the Insurance Board which reports to the Ministry of Finance. Investment guidelines are being written, specifying permitted investments for insurance companies which currently invest in government Bonds, National Savings Certificates issued by the government in 5 and 10 year maturities. bank time deposit, and on a very limited basis in equity shares (of unlisted companies).

E. Constraints

An appropriate enabling environment is key to the functioning of a credit rating agency. To provide meaningful and effective ratings, accounting systems, audited financial statements, disclosure rules, filing procedures and professional business practices must be in place. Existing regulations and conditions in Nepal pose major constraints, some of which are highlighted below. Appropriate regulations, supervision, monitoring, and enforcement need to be considered.

1) Companies are currently permitted to issue loans and debentures with certain conditionalities, under the Company Act (Section 25). If the issues are to be collateralized with the company's assets then the Ministry of industry must give prior approval. If the issues are not offered with collateral, and the amount of the loan or debenture does not exceed 50% of paid-up capital, then notice must be filed with the Ministry 7 days prior to issuance.

The prior approval of the Ministry of Industry to issue secured debentures or to give notice prior to issuing unsecured debentures causes undue delays and places restrictions on a company's ability to obtain financing. As a publicly traded instrument, the overall creditworthiness of the issue should be reviewed and approved by the Securities Board in its capacity as regulator, not by the Ministry of Industry.

2) The current procedure for purchasing shares and debentures consists of submitting an application to the company's Board of Directors, and putting up at least 10% of the value of the securities. Allocation and distribution of issues must take place within 6 months. The company must maintain a register of bond and debenture holders (as well as shareholders register). However, such a procedure is too cumbersome from the company's perspective, and too discretionary from the investor's perspective; leaving it up to the Board to determine whether or not to approve the sale to a particular investor. Instead, a centralized registry and transfer agent should be set up to handle these functions for all companies. thus reducing costs and duplication of efforts. Further, an advance payment of at least 10% of the value is costly for the investor as it ties up funds, without the benefit of earning interest. for periods of up to 6 months or longer.

3) Full disclosure of information regarding the promoters, the board of directors, financial statements and other relevant issuer information is now seriously lacking. While companies are required by the Securities Exchange Act and the Company Act to submit prospectuses to the Securities Board and the Company Registrar, respectively, there is no assurance that disclosure is full and reliable. The formulation and enforcement of company disclosure requirements is vague. No one regulatory authority has been specifically entrusted with the responsibility. The Company Registrar has thus taken upon itself the role of protector of public investors, even though the amended Securities Exchange Act of 1993 specifies that the Securities Board is responsible for investor protection. The authority to formulate disclosure rules, insider trading rules, etc. should thus be the domain of the Securities Board as the

principal guardian of public investors. Enforcement regulations and procedures by the Securities Board should also be addressed.

4) Interest rates on corporate bonds and debentures are set by Nepal Rastra Bank. In a market-driven environment, pricing is corntnonly determined by the investing public. Pricing mechanisms are typically guided by government securities traded in the secondary market, which is not permitted in Nepal. Nonetheless, NRB should minimize its involvement in pricing corporate bonds and debentures, although it could offer some guidance to the Securities Board and the financial intermediaries.

5) International accounting standards will be introduced in Nepal within 2 years. In the meantime, generally accepted standards and practices of accounting are lacking. There is no system for chartering (certifying) accountants, although Nepal Rastra Bank has a list of "authorized" accountants who may audit banks and state-owned enterprises. In addi tion, auditors are not held responsible for faulty audits of financial statements. Audited financial statements are not always reliable, as they are often manipulated to avoid taxes. Despite the requirements by the Company Registrar and the Securities Board (for publicly traded companies) to submit audited financial statements regularly, they are rarely presented on timely basis. The Ministry of Industry, as authority over Company Act, should require companies to publish quarterly financial statements in the newspapers. The Company Act is presently being revised to require the publication of annual financial statements of listed *companies.*

6) The size of the capital market is relatively small as is the number of active investors, although existing demand reflects substantial liquidity. It is estimated that only 50% of money in circulation is on deposit in the banking system. The size of new corporate issues coming to market ranges between NRs 1 2 million (US$ 245,000) and NRs 36 million (USS 735,000), with an average of NRs 20 million (US$ 407.000). It is believed that the largest group of stock market investors is comprised of 200-300 individuals and 3 of' the finance companies (market makers). Companies in Nepal do not usually invest in shares of other companies, preferrin g to makc dircct invcstments in other companies rather buying company shares on the secondary market. Institutional investors (banks, insurance companies. etc.) tend not to invest in publicly traded shares (except their own). However, all this may change as demand for longer term fixed-rate instruments grows from the institutional investors and provident funds, and as privatization moves ahead.

7) The Company Registrar's Office maintains the centralized registry of all companies. The companies are required to submit prospectuses, financial statements and other documents to qualify for share issuance. None of the documents filed with the Office. however. are made public. The flow ot information on public companies is virtually non-existent in Nepal. Although it is said that approximately 2,000 prospectuses are printed with each new issue, distribution is limited. Updates on company activities, including financial performance. are not unobtainable. As the only centralized source of information on companies, information on file at the Company Registrar's Office should be made available to investors, the financial

sector, and other interested parties. Clearly, a credit rating agency would benefit from accessing such information to analyze a company's financial and operating performance, its Board of Directors and management, and share ownership.

IV. RECOMMENDATIONS

Based on discussions with the National Planning Commission, the Nepal Rastra Bank, the Securities Board, the Nepal Securities Exchange, government officials, bankers, financial intermediaries, insurance company, and corporate executives, the findings were formulated into the following recommendations. A preliminary set of recommendations were distributed on a limited basis and discussed with the National Planning Commission and the Nepal Rastra Bank prior to departure. Comments were incorporated and a few points either further elaborated or refined in this version, but the general content has remained unchanged.

A. CREDIT INFORMATION BUREAU (CIB)

The stated activities of CIB include the collection and dissemination of information, preparation and circulation of a "blacklist", and analysis of information to assess credit risk. These are all functions related to loans and within the scope of the banking sector. Accordingly, it is proposed that the natne of CIB be changed to the "Loan Information Bureau" (LIB) so as to better reflect its actual function. The following are some proposed recommendations for the structure and operations of LIB:

1) LIB should be placed under the control of Nepal Rastra Bank (NRB), possibly as a department or unit within NRB, which would manage and operate the Bureau.

2) LIB's activities need to be clearly defined, with a focus on:

    Collection of information from banks and other financial institutions on outstanding loans, in amount exceeding Rs. 1.0 million:

    Collection of information on past due and defaulted loans above NRs. 500,000;

    Development of a centralized database for monitoring loans, lenders and borrowers;

    Preparation of weekly/monthly reports to the Inspection and Supervision Department within NRB;

Providing information on loans/borrowers to banks and other financial institutions only upon written reauest by an authorized official of the institution, in contrast to the current situation whereby the "blacklist" is circulated freely to all members banks, which is in breech of confidentiality practices. This acts as a disincentive for banks to comply with the reporting requirement, as it has the potential to undermine the bank's relationship with its client(s);

Developing statistical reports on loans for NRB;

Ensuring that confidentiality on loans and borrowers is maintained;

Assuring that banks and financial institutions comply with NRB's reporting requirements related to LIB's activities.

3) LIB should not be involved in either risk assessment or grading of loans, as loan grading is a function performed by the banks themselves and reviewed by NRB's auditors.

4) Given the types of information that CIB collects on loans--maturity dates, types of credit facilities, collateral and its location, name and nature of business -- it could constitute a valuable resource. CIB/LIB could produce monthly or annual statistical reports on industries and sectors by loan type, collateral type, geographic distribution, and loan demand (seasonal, regional, sectoral). Such reports could be useful tools for NRB as well as government planning offices and ministries. The information should be made publicly available for research purposes by institutions and for marketing purposes by the business community. But it must exclude certain sensitive information such as the loan amount by designated borrower. Loan activities are confidential and should not be disclosed outside or even within the banking community. except under strictly regulated conditions.

5) A review of the systems and procedures for information gathering by the Bureau should be undertaken by an expert familiar with the operations of this type of bureau.

6) Institutional and capacity strengthening of the Inspection and Supervision Department of NRB, through a provision for technical assistance and training of staff of the Department and LIB. A banking regulations and supervision expert(s) should review the existing rules, regulations, and procedures related to auditing, reserves for bad debt and loan classification system, and enforcement of these.

(Separately, a loan recovery program shoufd be implemented as this would ensure at least a partial collection of past due and defaulted loans. Loan recovery endeavors would incorporate loan restructuring initiatives, which should substantially reduce the number of blacklisted borrowers who now have little or no leeway to negotiate their defaulted loans. The banks. under the guidelines of the Nepal Rastra Bank, could adapt loan restructuring packages that include, for example, additional collateral from the borrower or guarantor, renegotiated interest rates, a more feasible loan repayment schedule, additional short-term working capital loans (if necessary), and possibly converting all or a portion of outstanding debt into equity. Blacklisted borrowers who are now perceived as posing a major threat to the entire financial sector could be legitimized. Relief from debt burden and the possibifity to access working capital credit could lead to expanded business opportunities for these blacklisted borrowers, ultimately creating more productive enterprises rather than bankrupt businesses.)

B. CREDIT RATING AGENCY (CRA)

Credit rating agencies are a function of capital markets activities, utilized to facilitate investments in debt instruments that include debentures, bonds and preference shares. The capital market in Nepal is in its nascent stages and the issuance of debt instruments is very moderate. Notwithstanding, two companies have already expressed interest in forming credit rating agencies. One of these or possibly both are engaged in other capital markets activities, which could pose conflicts of interest. Consequently? the following recommendations take into consideration some of these factors and are intended to create the proper enabling environment for a credit rating agency whose goal should be to protect the investing public.

A. It is recommended that credit ratings on publicly issued debt instruments should be made <u>mandatory</u>. The rationale being that, in the initial stages, it helps to create necessary disciplines in the market. Ratings also promote capital markets activities. However, rating activities should he undertaken by trained professionals, under accepted guidelines, and wi thin the proposed structure outlined below. Rating agencies, unlike regulators, have no powers of enforcement of disclosure or other information requirements. It is the task of the regulator (in this case the proposed Securities Board, as seen below), to enforce filing and other regulations related to issuance of debt instruments.

B. Proposed Structure and Organization

<u>Name:</u> Nepal Investment Information Service and Credit Rating Agency (NIISCRA).

Activities of NIISCRA

Given the state of Nepal's capital markets and the constraints identified above, the demand for the services of a credit rating agencies can be viewed as being in the formative stages. The lack of basic information regarding publicly traded companies and state-owned enterprises: which are earmarked for privatization, also hinders credit rating efforts. Recognizing these drawbacks as well as opportunities, it was determined that combining these elements would be the most practical approach, It was also decided to conceive of NIISCRA in developmental terms. Beginning with the creation of a business **data** base, eventually it would grow into a full-fledged credit rating agency that would utilize the database in its analysis of companies issuing debt instruments. To make it a sustainable operation, NIISCRA could also perform other related services. Accordingly, the principal activities of NIISCRA were conceived of as follows:

a) Developing and maintaining a business database on: publicly-traded companies, state-owned enterprises, and other companies. The information in the database will be derived from prospectuses filed with the Securities Board, the Registrar of Companies, ministries, and directly from the companies themselves.

b) Publishing a "fact-sheet" on companies in the database for sale/distribution to: foreign and domestic investors, government offices, and other companies.

c) Providing fee-based Credit Assessment services, on demand, to banks and financial institutions, companies, investors, and ministries. In addition, banks may wish to obtain an independent, third-party assessment of a credit proposal that they are reviewing. NIISCRA would be contracted to perform the assessment by analyzing financial statements, company operations.

d) Undertaking credit rating services, utilizing internationally recognized symbols, standards, and criteria.

Legal Structure of NIISCRA: Registered as a company under the provisions of the Company Act.

Authorization and Supervision: The Securities Board should authorize the establishment of NIISCRA, and supervise its activities to ensure compliance with the stated guidelines and practices. Prior to commencing operations, a set of rules and guidelines would need to be developed and approved by the Board and/or the Ministry of Finance.

(Under an existing provision of the Securities Exchange Act of 1983 [Chapter II, Section 3 (1)], it is stated that "a Securities Board shall be established in order to systematize and regularize the transaction of securities and to develop Stock Exchange by protecting and promoting the interest of the investors". Similarly Rule 3 of the Securities Exchange Regulation of I993 defines one of the functions of the Securities Board is to "enhance the development of capital market by preserving and protecting the interest of the investors". Accordingly, these broad provisions would appear to enable the establishment of NIISCRA under the powers and authorization of the Securities Board).

<u>Shareholders:</u> Commercial banks, joint-venture banks, insurance companies, finance companies, and possibly NIDC Capital Markets would constitute the most likely shareholders as they are sources or expertise and financial resources ("deep pockets").

<u>Board of Directors:</u> Should be broad-based and independent, comprised of 2 chartered accountants, experts in finance, industry, and economics. Director5 who will serve on the Credit Rating Cornrnittee should rotate, serving 2 year terms.

<u>Management and</u> Staff: One managing director, 2-3 credit analysts, and 2 support staff.

C. Initial capital of approximately Rs. 30 million. or a sufficient amount to sustain operations for at least 2 to 3 years.

D. Insurance coverage for credit rating risk should be obtained to cover potential liabilities resulting from gross negligence, fraud, insider information, etc. The Nepal Life and Property Insurance Co. Ltd. has agreed in principle to consider underwriting such risk.

E. It is highly recommended that a NIISCRA Steering committee be formed as soon as possible, comprised of the Securities Board, Nepal Rastra Bank, and financial institutions (as prospective shareholders). The tasks of the Committee will include:

1) establishing professional, ethical and quality standards as well as code of conduct for NIISCRA;

2) formulating a regulatory framework for credit rating services, including monitoring and reporting procedures, and statutory basis for the agency;

3) recommending and facilitating appropriate rules and regulations (e.g. disclosure rules for public companies) for credit rating services in Nepal;

4) identifying potential shareholders and obtaining a commitment for funding and support

F. It is recommended that institution and capacity building be undertaken through training of staff by internationally recognized credit rating agencies, which could also provide guidance in developing the business database, credit rating criteria, and analytical training.

G. As the Securities Board will be the authorizing body for the Agency, institution and capacity building should also be considered for the Board so as to ensure that proper regulatory, supervisory and compliance provisions relating to filing requirements, disclosure and enforcement are incorporated into the Securities Exchange Act and that the Board's mandate is clearly defined. Provisions concerning the issuance of debt instruments, under the Company Act (Company Registrar) and the Securities Board and the Securities Exchange Act need to be cross-referenced to avoid duplicity and ensure uniformity of rules and procedures. Guidance on pricing mechanisms for debt instruments should also be provided to financial intermediaries and regulatory authorities.

H. Two individuals (one from the Securities Board, the other from Nepal Kastra Bank) should participate in an upcoming International Conference on Credit Rating to be held in New Delhi at the end of August (Annex C is the conference schedule). US AID has given preliminary approval of support.

I. The United States Securities Exchange Commission annually holds a 2-week course (free of charge) for regulatory officials from developing capital-market economies. The next program is scheduled for Spring, 1995. It is recommended that the head of the Nepal Securities Board and the Nepal Stock Exchange attend this program. Annex D contains information on the program, Arrangements have been made to send applications to the two individuals, and completed forms should be submitted by December.

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RATING SYMBOLS

The following rating symbols are typically used for long-term ratings, however they are utilized for medium-term ratings with minor variations.

* "A" - issues rated in this category demonstrate the highest probability for repayment.
  - AAA -risk factors are negligible
  - AA protection factors are strong, risk is modest with strong capacity to pay interest and repay principal
  - A -risk is average but adequate, somewhat more susceptible to adverse effects of economic conditions and circumstances than higher rated categories.

* "B" -issues have a reasonable probability of timely payment but could be affected by changing conditions.
  - BBB -satisfactory but below average protection factors, adequate protection parameters, but considerable variability in risk during economic cycles
  - BB -speculative character, below-investment grade, faces major on-going uncertainties, fluctuating financial, economic and business factors
  - B -greater vulnerability to default, impairing willingness or ability to pay interest and repay principal

* "C" -issuers have doubtful probability of timely payment, substantial risk
  - CCC -identifiable vulnerability to default
  - CC -minimal protection, default in payment of interest and/or principal is probable over time
  - C - imminent default in payment of interest or principal

* "D" -debt is in default which is assigned on the day that an interest or principal payment is missed, and issuer has filed for reorganization or liquidation (bankruptcy).

Annex C

ICRA

INTERNATIONAL CONFERENCE ON CREDIT RATING

PROGRAMME

August 30, 1994

09.00 hrs	Registration
09.30 hrs	Welcome Address by Mr.D.N.Ghosh, Chairman, ICRA
10.00 hrs	Inaugural Address Dr.Manmohan Singh, Union Minister for Finance
10.30 hrs	Tea/coffee break
11.00 hrs	**FIRST TECHNICAL SESSION - RATING OF CORPORATE DEBT** Chairman Mr.S.S. Nadkarni, Chairman, SEBI # Moody's Investors Service, U.S.A. # Japan Credit Rating Agency Ltd., Japan
13.00 hrs	Lunch
14.00 hrs	**FIRST TECHNICAL SESSION** *CONTINUED* Thai Rating & Information Services, Thailand MAALOT - The Israel Securities Rating Co.Ltd.,Israel Rating Agency Malaysia, Berhad, Malaysia
15.30 hrs	Tea/coffee break
16.00 hrs	Panel Discussion

August 31, 1994

(39.30 hrs	**SECOND TECHNICAL SESSION - RATING OF BANKS AND FINANCIAL INSTITUTIONS** Chairman Mr.D. Basu, Chairman, State Bank of India IBCA Ltd. U.K.
11.15 hrs	Tea/coffee break
11.45 hrs	**SECOND TECHNICAL SESSION-COMD.** Thomson Bankwatch Ltd., U.S.A.
12.30 hrs	Panel Discussion
13.00 hrs	Lunch
14.00 hrs	**THIRD TECHNICAL SESSION - RATING OF EURO ISSUES** **Chairman** Dr.M.S. Ahluwalia, Finance Secretary # Standard & Poor's Corporation. U.S.A. Japan Bond Research Institute, Japan
16.00 hrs	Tea/coffee break
16.30 hrs	Panel Discussion
17.00 hrs	*Valedictory* ***Address*** Dr.C.Rangarajan, Governor, RBI #

NOTE : # Subject to Confirmation

Annex D

The SEC's fourth annual International Institute for Securities Market Development will be held at our headquarters in Washington, D.C. from April 25 to May 6, 1994. The Institute is an intensive program of lectures, seminars and workshops on the development and oversight of securities markets. It is intended for senior government regulatory or stock exchange officials from countries with emerging securities markets.

The Institute provides an excellent way for the SEC to share nearly three generations of practical experience in overseeing the U.S. securities markets with officials faced with the challenge of building securities markets that will foster capital formation and economic growth. The Institute's faculty includes senior officials from the SEC, other government agencies such as the Federal Reserve System, multinational development organizations, U.S. securities exchanges and other major securities market institutions. These officials have provided a special dimension to the Institute's conferences by sharing their knowledge and experience.

The Institute is the centerpiece of the SEC's technical assistance program. Over 260 delegates representing 62 emerging market Countries have participated in its programs.

Following the completion of the two-week program in Washington, delegates will have an opportunity for internships with private securities firms and organizations located throughout the U.S. The Institute and internship program provide an excellent opportunity for delegates and faculty to exchange ideas and to foster international cooperation in building dynamic securities markets around the world.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

OFFICE OF INTERNATIONAL AFFAIRS
450 FIFTH STREET, NW
WASHINGTON, D.C.
20549

Sincerely,

Arthur Levitt

Arthur Levitt
Chairman

INSTITUTE PROGRAM
April 25 - May 6, 1994

TOPICS OF THE TWO-WEEK PROGRAM:

AN OVERVIEW

- Welcome by SEC Chairman
- Program Overview

MARKET DEVELOPMENT

- Capital Mobilization through Securities Markets
- Financial Sector Development
- Policy Framework for Securities Market Development
- Privatization and Capital Markets
- Building Public Confidence
- Regulatory Alternatives

SECURITIES OPERATIONS

- Corporate Finance and Underwriting
- Back Office Operations
- Clearance and Settlement
- Automation and Electronic Trading
- Money Management
- Portfolio Investment in Emerging Markets
- Government Securities Markets
- Rating Agencies
- Exchange and Over-the-Counter Markets
- Cross-Border Equity Offerings

SECURITIES REGULATION

- Legal Framework for Securities Markets
- Role of the SEC
- Self-Regulatory Organizations
- Disclosure Program and Capital Formation
- Oversight of Exchanges and Markets
- Market Surveillance Techniques
- Oversight of Financial Firms
- Investment Management Regulation
- Detection and Suppression of Fraud

WORKSHOPS AND DISCUSSIONS

- Workshop: Full Disclosure Program
- Workshop: Investment Management Regulation
- Workshop: Market Regulation Program
- Workshop: Enforcement Program
- Workshop: Accounting and Auditing
- Workshop: Regional Issues and Developmental Strategies
- Discussion of Regulatory Policy Issues
- Discussion of Technical Assistance Needs

ORGANIZATION OF PROGRAM

Panels and workshops will be conducted at the SEC headquarters in Washington, D.C. These will be led by SEC faculty, officials from other U.S. government agencies, multilateral development organizations, stock exchanges and at her self-regulatory organizations, and experts from private-sector investment banking, law and accounting firms. In order to enhance our program, we request that a representative of each participant country present a profile of its securities markets and regulatory structure, including recent policy and structural developments.

OPTIONAL INTERNSHIPS

Following the institute's formal two-week conference in Washington, there will be an opportunity to intern or consult with one or two securities market organizations in other financial centers. These internships consist of small group meetings, conferences and consultations over a period of three to five days.

3. ***Securities Regulation.*** Securities markets require a sound legal and regulatory infrastructure. This is essential to establish enforceable contract rights, and to foster responsible behavior by all market participants. This part of the program will address the interrelationships among regulation by statute, rule, order, industry self-regulation and private contract.

The following four key areas of securities regulation will be covered:

- Regulation through a system of full and fair disclosure, including financial reporting;

- Market regulation, including minimum standards for licensing and regulation of securities brokers and other intermediaries, customer protection rules, capital adequacy standards, brokerage firm and stock exchange inspection procedures, market transparency, clearance and settlement safeguards, vigilant market surveillance, and avoidance of barriers to fair competition;

- Investment management regulation, including objective criteria far the purpose, form, capitalization and management of investment funds, disclosure practices, fairness in pricing, prohibitions on affiliate transactions, safeguarding fund assets, and investment adviser licensing and regulation; and,

- An enforcement program, designed to protect investors and preserve the integrity of the securities markets, which provides for adequate investigatory authority and remedies with respect to insider trading, market manipulation, financial fraud, and violations by regulated persons.

ATTENDING THE INSTITUTE

Who Should Attend. The Institute is designed for senior government regulatory and stock exchange officials from countries with new or emerging securities markets. In order to accommodate all emerging market counties, generally, no more than two delegates per organization can be accepted.

Applications. Information on how *to* nominate delegates to the Institute and other details are included in the Institute application form. These may be obtained from tie *SEC's Office of International Affairs*, whose *address, phone* and fax numbers appear on the inside back cover of this brochure.

Language. All Institute programs will be presented in English. Translation services are not available.

Costs. There is no tuition charge. Delegates are expected, however, to arrange and pay for all transportation, accommodations and subsistence expenses. Delegates may be able to arrange funding for their expenses through the U.S. Agency for International Development or international organizations that fund technical assistance. Delegates to the conference are also strongly encouraged to obtain travel and medical insurance.

INTERNATIONAL INSTITUTE FOR SECURITIES MARKET DEVELOPMENT

The 1990s have become the decade of financial sector reform. Countries around the globe are establishing or invigorating securities markets. To further market development, capital formation and the building of sound regulatory structures in these countries, the U.S. Securities and Exchange Commission formed the *INTERNATIONAL INSTITUTE FOR* SECURITIES MARKET DEVELOPMENT in 1991. More than 260 officials from five continents have participated in the Institute's three annual conferences. These delegates have included numerous chairmen, commissioners, presidents and general managers of securities commissions and stock exchanges, as well as high-level capital market officials from ministries of finance and central banks. They represent emerging markets with a highly diverse set of policy priorities. In some cases, the development of the securities market is vital to support economy-wide privatization programs. In other cases, the securities markets are rapidly maturing with technological and market consolidation issues at the forefront. The Institute has benefited tremendously from the enthusiastic input of these many talented delegates to the first three conferences.

PROGRAM CONTENT

The Institute program covers both policy and operational issues related to the develop ment, functioning and regulation of securities markets. The following is a broad overview.

1. ***Market Development.*** Sound securities markets foster capital formation and economic growth. Government can lay the foundation for market development by establishing an effective legal and policy framework that encourages capital formation, competition in the financial sector, fair and efficient secondary markets, and strong investor protection standards. The Institute program includes panels and workshops on strategies far securities market development, and the role of capital markets in facilitating privatization. Because the globalization of securities markets has increased cross-border investment flows, international offerings, and foreign listings, the Institute will also include presentations on what foreign investors look for in emerging markets, and the means by which foreign issuer; can access U.S. markets.

2. ***Securities Operations.*** The Institute draws upon the experience of U.S. securities market participants and representatives from emerging markets to explain how securities transactions are conducted. Topics include brokerage operations, investment banking, investment advice and investment management. Emphasis will be placed on the process of designing and bringing different types of securities issues to market, and the operation of efficient secondary markets. These presentations will provide an in-depth look at trading systems, including differences between dealer and order driven markets, quotation and trade reporting practices, and clearance and settlement. Innovations in communications and computer technology also will be discussed.