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FS SERIES #6: DEVELOPING CORPORATE BOND MARKETS IN EMERGING ECONOMIES

MODEL SCOPE OF WORK

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ACRONYMS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABS	asset-backed security
AIMR	Association for Investment Management and Research
BD	broker-dealer
CML	certified mortgage lending
CMO	collateralized mortgage obligations
COTR	contracting officer’s technical representative
DCA	Development Credit Authority
GDP	gross domestic product
IAIS	International Association of Insurance Supervisors
IAS	international accounting standards
IFI	International Financial Institute
IFRS	international financial reporting standards
IG	investment-grade
IMF	International Monetary Fund
IO	interest-only
IOSCO	International Organization of Securities Commissions
IPO	initial public offering
KASE	Kazakhstan Stock Exchange
KMC	Kazakhstan Mortgage Company
LIBOR	London Interbank offered rate
LTV	loan-to-value
MBS	mortgage-backed security
MSOW	model scope of work
NBFI	non-bank financial institutions
NBK	National Bank of Kazakhstan
NSC	National Securities Commission (Kazakhstan)
NYSE	New York Stock Exchange
OECD	Organization for Economic Co-operation and Development
OTC	over-the-counter
PO	principal-only
QSPE	qualified special-purpose entity
REMIC	real estate mortgage investment conduits
RMBS	residential mortgage-backed security
SEC	U.S. Securities and Exchange Commission
SIFMA	Securities Industry and Financial Markets Association
SME	small- and medium-sized enterprises
SOW	statement of work
SPV	special-purpose vehicle
TNA	training needs assessment
USAID	United States Agency for International Development
USG	United States government

INTRODUCTION

The United States Agency for International Development (USAID) Bureau for Economic Growth Agriculture and Trade (EGAT) created the Financial Sector Knowledge Sharing Project (FS Share) to collaborate with USAID missions to develop effective and efficient financial sector programs that increase access to financial services and develop well-functioning markets worldwide. USAID awarded Chemonics International, Inc. the FS Share delivery order under the Financial Sector Blanket Purchase Agreement. FS Share has a three-year period of performance, July 2008 through July 2011.

Through the FS Share Task Order, USAID/EGAT and Chemonics proactively collaborate with missions to identify financial-sector priorities and develop strategies and programs for growing the financial sector. FS Share identifies financial-sector best practices and aggregates them through model scopes of work (MSOW), primers, diagnostic tools, best practice case analyses, and other tools. These deliverables are disseminated to USAID missions for use in financial-sector programs. FS Share can assist with implementation and connect mission staff to external resources on best practices. In response to mission demand, FS Share delivers presentations and other knowledge-sharing endeavors.

Objective of this FS Series

The objective of this FS Series, *Developing Corporate Bond Markets in Emerging Economies* is to provide U.S. government (USG) program designers with a basis of technical understanding of corporate bond issuances and approaches to developing a sustainable corporate bonds market in emerging economies. The FS Series includes a Primer, a Diagnostic Checklist, and an MSOW. The primer introduces financial intermediation using capital markets, provides an analysis of lessons learned and approaches from existing literature, resources and the first-hand experience of the authors, and presents four representative case studies. The diagnostic checklist is designed for USG programmers to use to make a preliminary evaluation as to whether the fundamental legal and regulatory, market, and governmental support pre-conditions are in place for developing a viable and sustainable corporate bond market. The MSOW provides sample language to integrate into effective programming. **This is the MSOW.**

This FS Series was developed by FS Share subcontractor PRAGMA Corporation. The FS Series was reviewed and edited by Chemonics International.

FS Share Rapid Response Hotline

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MODEL SCOPE OF WORK

Model Scope of Work (MSOW) for Development of Corporate Bond Markets

This section provides a generic MSOW for developing a viable and sustainable corporate bond market.

The contractor will work to accomplish the tasks and sub-tasks set forth under each of the Project Components below.

Project Components

Component 1: Develop Issuance Capacity

Task 1.A. Develop the domestic government securities market

Objective: An adequate level of domestic government securities issued at market that market participants can use to construct a long-term yield curve for reference in the pricing of all other domestic fixed-income securities.

Description: Domestic government securities markets usually begin as primary, with retail and institutional investors buying for their own account. Later, as circulation builds, a secondary market develops, with trade executed on exchanges or through an institutional dealer network (OTC) — typically negotiated by telephone. Domestic government securities markets also bring settlement, custody, and delivery mechanisms to world standards, which is a precondition for any trade in fixed-income instruments. The challenge is for governments to construct (i.e., issue laddered maturities and successfully place them in the market) and maintain (i.e., establish a regular auction calendar of pre-announced amounts for the dealer community, with subsequent secondary market trade) a long-term government yield curve of at least five to seven years that can be used as the "risk-free" benchmark for the pricing of all other securities. Having a liquid government domestic securities market facilitates development of market infrastructure that involves market participants and supports development of a corporate bond market.

Sub-Task 1.A.1. Develop a government debt-management strategy and issuance framework

Objective: For the market to have a clear legal perspective (i.e., transparency) of the government's annual borrowing needs and objectives for borrowing, a clear delineation of what agency is charged with its execution, and its governance structures; to understand how the agency will carry out the process, its operational structure, how risk will be managed using market rates, a description of how activities with the central bank will be coordinated, and clear reporting requirements to the government.

Description: Pre-announced auctions with predetermined amounts, coupled with operational clarity, give buyers of government securities a sense of security that the government knows what it is doing and there will be no surprises. This approach contributes to market confidence and helps build liquidity. Accordingly, the contractor should:

- Sponsor a conference on debt management for senior policymakers from government, the central bank, and the market to discuss ways of building confidence.
- Produce a summary note that sequences reforms and recommends that government form a working group comprising representatives from finance, the central bank, and market participants.
- Have the working group produce a concept note that recommends the government prioritize development of the domestic government securities market and reference the importance of adopting a debt-management strategy and operational framework using market rates. The concept note should also outline what steps the government should take to develop the market.
- Sponsor trips for senior officials to attend the biannual OECD/World Bank/IMF conferences on debt management.
- Invite senior leadership to a second annual conference to assess progress in public debt management and policy issues under consideration.
- Offer to function as a resource for government regarding any analysis needed in conjunction with implementation of the concept note.

Sub-Task 1.A.2. Develop the primary market and benchmark issues

Objective: A liquid and robust short-term treasury market that builds market participants' confidence and leads to successful issuance of securities with three- and possibly five-year maturities.

Description: Like individuals, governments try to borrow for the least amount of interest and risk. Its daily management of treasury balances reflects seasonal income from tax collections and ongoing expenses. To fund these differences, government has to borrow, sometimes for very short periods. Unlike individuals, government has a legal right to borrow and the unique power to tax and service its obligations. This is the main reason why government obligations are widely regarded as the least risky benchmark at the national level. Accordingly, to assist the development of the primary market through expanded government issuance, the contractor should:

- Facilitate regular meetings — biweekly, for example — with institutional investors such as banks and the head of public debt at the ministry of finance to discuss market appetite for three-, six-, nine-, and 12-month treasury issues to build the short end of the yield curve and the primary market.
- Assist the head of public debt to evaluate the use of short-term treasury issues in the interbank market.
- If possible, facilitate monthly meetings between the head of public debt and his counterpart at the central bank to discuss coordination of issuance and, in the absence of a debt-issuance calendar, the introduction of repos/reverse-repos to facilitate cash management at the ministry of finance.

- Assist the head of public debt to evaluate the merits of establishing and using primary dealers versus using the auction market.
- Work with the head of public debt to analyze the effectiveness of the auction process and what steps to take to broaden market participation.
- If appropriate, establish selection criteria for primary dealers that include obligations and incentives.
- Assist the head of public debt to select a few key benchmark issues for concentration and construction of a long-term yield curve.
- Facilitate meetings with the head of public debt and asset managers of mutual funds, pension funds, and insurance companies to discuss the optimization of maturities and reception to the introduction of inflation-indexed securities.
- Assist the ministry of finance to evaluate the benefits of establishing a separate office devoted to debt management.

Task 1.B. Develop the primary mortgage/housing market and establish the main building blocks for the secondary mortgage market

Objective: A mortgage market that makes home ownership affordable and accessible to as many borrowers as possible by introducing prudent underwriting standards and risk-management practices to lenders.

Description: There is increasing interest in mortgage lending among commercial banks and credit organizations. Having an established mortgage market also facilitates development of a corporate securities market through issuance of mortgage-backed bonds. These instruments facilitate the ability of lenders to refinance their mortgage portfolios. This contributes to liquidity and a lower cost of funds for financial institutions that is beneficial to borrowers and provides financial instruments for investment.

Review of existing legislation is necessary to facilitate the development of the primary mortgage market and ensure that the rights of creditors and borrowers involved in mortgage lending are secure. In so doing, it is necessary to provide or amend the legal framework, as needed, so the primary and secondary mortgage market can develop. To enhance the capacity of lenders to identify and mitigate the risks associated with real estate lending, they must be educated in mortgage-lending techniques, risk management, valuation, and appraisal methodologies. This includes educating the regulatory body charged with oversight of banks that have mortgage- and real estate- lending portfolios.

The contractor will work to develop the primary mortgage market while anticipating development of the secondary mortgage market by emphasizing standardization, risk management at both commercial banks/credit organizations and the bank regulator, and new lending technologies. The contractor will also focus on addressing issues including legislative drafting; further developing collateral and pledge registries, and increasing their availability; and improving the capacity, knowledge, skills, and activities of commercial banks and/or credit organizations and the country’s bank regulatory staff. To prevent overlap, these efforts should be coordinated with other donor organizations that intend to offer assistance in this area.

Sub-Task 1.B.1. Mortgage-lending education

Objective: Educate and develop mortgage practitioners who will contribute to the development of the primary mortgage market by using underwriting standards that will permit evolution of a secondary market.

Description: The contractor will introduce certified mortgage lending (CML) training developed in Russia with USAID's support and used successfully in Russia, Kazakhstan, Ukraine, Moldova, Transnistria, and Azerbaijan. The CML program consists of a series of three five-day courses: "Basics of Mortgage Lending," "Mortgage Loan Origination and Servicing," and "Basics of Pricing and Risk Management in Mortgage Lending." The program is based on a comprehensive study of methodological, economic, and legal aspects of residential mortgage lending, including insurance and appraisal of housing, pricing problems, evaluation, and management of bank risks. Special attention is given to loan origination technology, borrower underwriting, and calculation of loan payments. The program includes computer skill-building sessions and business games. Its participants are introduced to experiences in the United States, Germany, and other countries; different models of the primary and secondary mortgage markets; the attraction of resources, including various construction saving schemes; and the issuance of MBSs and mortgage bonds. The organizational aspects of the emerging mortgage systems in Russia, Kazakhstan, Ukraine, Azerbaijan, and other transitional economies will play an important role. The contractor will evaluate the CML program and adapt it to reflect the country's legal and regulatory environment.

Participants who complete the full training course and successfully pass the exams will become highly qualified experts with a sound knowledge of the main components of the residential mortgage-lending process, including:

- Legislative and regulatory framework for mortgage-lending operations and standard loan document forms
- Loan underwriting and origination procedures
- Servicing of mortgage loans and ensuring their repayment
- Loan instruments
- Risk management in relation to home mortgages
- Pricing of mortgages
- Refinancing of home mortgages
- Formation and functioning of the secondary mortgage market
- Issuing and circulation of mortgage securities

Accordingly, the contractor will deliver a series of three CML courses, including at least two in the first year and, subject to demand, additional ones in the second year. These courses will be offered in collaboration and cooperation with local training institutions selected by the project and approved by the contracting officer's technical representative (COTR). For the second year, trainers from the institutions should deliver the courses themselves, with the contractor observing. The contractor will administer the tests that are part of the modules and will issue certificates to those who pass. It is envisioned that training institutions will offer these courses on a commercial basis. Thereafter, as requested and required, the contractor will offer specialized mortgage training and consulting to commercial banks. Testing of candidates will demonstrate knowledge of:

- Steps, processes, procedures, and components of mortgage lending
- Legal framework for mortgage lending
- Rules and procedures for mortgage lending
- Mortgage loan underwriting
- Computation of debt service payments for a variety of mortgage loans
- Risk management of mortgage interest rates
- Risk management of mortgage credit
- Legal aspects of mortgage lending
- Global mortgage lending practices
- Peculiarity of interplay among mortgage market participants
- Primary and secondary mortgage markets
- Specific features of different mortgage securities
- Issuance of mortgage securities and the risk-management benefits that result from loan portfolio securitization
- The role and function of a secondary mortgage market
- Servicing of mortgage loans
- Mortgage pricing
- Mortgage insurance
- Property-appraisal methodology profile
- Housing valuation and market data

Sub-Task 1.B.2. Assist banks to undertake mortgage lending

Objective: Commercial banks and NBFIs establish mortgage-lending operations that offer affordable mortgage products that expand home ownership.

Description: This can be accomplished by lowering the risks associated with mortgage lending and improving the transparency of mortgage-lending practices by providing financial institutions with methodological assistance in mortgage lending, underwriting methods, and loan appraisal and administration that parallel international standards, practices and principles. The first stage is to create conditions that will make mortgage lending attractive to banks and NBFIs and result a mortgage market that is a real, functioning sector of the economy. Accordingly, the contractor will assist in developing:

- Mortgage loan instruments tailored to various market conditions (e.g., high, medium, and low rates of inflation) in a manner that will satisfy both bank and borrower interests
- Standardized, transparent procedures for borrower and loan security underwriting, including underwriting of mortgage loans, and disclosure documents
- Standardized mortgage loan documentation rules
- A system of contracts for legalizing mortgage transactions

- Standardized, transparent procedures for servicing mortgage loans, including necessary software
- Procedures for handling problem or bad loans

Sub-Task 1.B.3. Enable legal and regulatory environments

Objective: Secure legislation that protects a lender's right to recovery and foreclosure in the event of default.

Description: A major impediment to the development of mortgage markets is the difficulty lenders have taking back collateral in the possession of owners who have defaulted. A well-written mortgage law will define a mortgage and the rights and obligations of all who are party to a mortgage, and outline the process to be followed in the event of default. Difficulty arises when well-meaning law makers include provisions to protect the "socially disadvantaged" (i.e., those who are unable to pay). Such exemptions to the foreclosure process can slow market development if loopholes are found or "socially disadvantaged" is interpreted too broadly. The contractor should work with the local banking and mortgage association (if one has been formed) to craft legislation and implement regulations that clearly state what will transpire under *any* circumstance.

Accordingly, the contractor should work to enhance market development through:

- Developing legislation that allows long-term mortgage lending to grow
- An effective law that stipulates the basis for appropriate relations among market participants, provides for enforcement of obligations, and sets the requirements for real estate mortgages
- Inclusion of court precedents of foreclosure, including subsequent eviction of former mortgagors from the mortgaged premises
- Developing a unified system for registration of real estate rights that will greatly facilitate mortgage transactions

Sub-Task 1.B.4. Develop associated market infrastructure

Objective: Build the capacity of real estate brokers and appraisers so they will become organized, ethical, and skilled professionals.

Description: The contractor will conduct a needs assessment of the associations of real estate brokers and real estate appraisers to determine their capacities for self-sustainability, the products and services they offer, and compliance with international best practices, principles, and ethics. The contractor will design a training and capacity-building program, based on the assessment results, that will bring the associations into compliance with international norms. The contractor will also facilitate these associations' membership and participation in the respective international brokerage and appraisal federations.

Component 2: Development of Institutional Investor Capacity

Task 2.A. Support development of Pillar II pension funds for development of institutional investor capacity

Objective: Assist the recipient country in developing a strong, competitive, and well-regulated private pension system that safeguards against systemic risk yet flourishes to benefit the market and retirees alike. Develop a private pension system that protects retirees and workers against opportunistic behavior by providers of financial services while enhancing the efficiency of the recipient's financial system and promoting financial intermediation to the private sector.

Description: An accumulation system in an emerging market is dynamic; it requires constant monitoring, analysis, and policy adjustment. Pension reform can enhance the quality of life for everyday citizens through the economic growth it typically causes and the reliable provision of social services and benefit payments that the ongoing, rationalized retirement system delivers. In an accumulation system, all employers are required to withhold approximately 10 percent (depending on actuarial analysis) of each employee's wages and transfer it to an accumulation pension fund of the employee's choice. Contributions to the fund are invested on behalf of the contributor (i.e., the employee) and continue to accumulate until he is eligible for retirement. At that time, the employee may withdraw the accumulations as prescribed by law, along with payments from the old solidarity pension system if he worked prior to the conversion to the accumulation system. This is the person's retirement income.

The reformed pension system is designed to provide security to current retirees by providing a reliable source of retirement income. Pay-as-you go systems can accumulate large arrears, whereas an accumulations system benefits future retirees with both increased security and a considerably higher retirement income. Workers and retirees enjoy greater transparency, fairness, and efficiency under the reformed system. Furthermore, after the sizeable transition costs are funded, a country can expect to gain long-term budget benefits from the operation of a fiscally sound, largely privatized pension system. Finally, because worker contributions accumulate quickly, pension reform is the single most important determinant in forming institutional investor capacity.

Sub-Task 2.A.1. Support pension reform

Objective: Create the conditions necessary to convert from a state pay-as-you go pension system to a privately managed accumulation system.

Description: There are many issues to address prior to conversion to a pay-as-you go system. Government authorities must be assured decisions about converting to an accumulation system will be based on a completed analysis of the country's situation. Once the decision to convert has been made, officials can begin to develop legal and regulatory authority and address technical issues. Accordingly, the contractor will:

- Assist in development of demographic data and actuarial models to support the reform's initial policy design and monitor the system's continuing fiscal and actuarial viability
- Develop hardware and software systems to administer the collection and transfer of contributions to the accumulation system and process solidarity system payments
- Provide support to inform the public and key government personnel about how the system will operate
- Provide comments on the draft law and prepared language for amendments; prepare or assist in the preparation of all regulations required to implement the system
- Support the regulatory and supervisory infrastructure of the regulatory bodies that safeguard and monitor the operation of the system; assist in the establishment of sound, rational regulatory policies and practices; and provide extensive training to a large number of institutions and individuals involved in the reform effort
- Develop a core group of sound private pension funds
- Support the establishment of the institutional framework for pension administration and the processes for managing the system
- Provide assistance in the development of sound investment policies and additional financial instruments for pension investment

Sub-Task 2.A.2. Develop investment guidelines

Objective: Have regulatory authorities support investment guidelines that support fixed-income market development.

Description: Pension fund asset managers have a fiduciary responsibility to protect the capital they are charged with managing while working to earn a return. Consequently, in the early years of pension reform, managers will be risk-adverse and seek only investments that pay fixed amounts of interest while safeguarding principal. The challenge will be for market participants to structure, issue, and place enough fixed-income instruments to meet demand. Regulators will describe allowable assets and fix the percentages of allowed ownership in investment classes such as equities, fixed income, domestic, and foreign, and the requisite rating for each. Accordingly, the contractor will:

- Support the regulator in determining the appropriate level of investment in each asset class
- Assist the regulator in determining ways of valuing portfolios composed of securities that are traded infrequently; prepare a comparative analysis of how such valuations are done elsewhere
- Educate the regulator about new financial instruments (e.g., mortgage-covered bonds and asset-backed securities) and their levels of risk.
- Facilitate periodic meetings between asset managers and the regulator to discuss different financial instruments' risk parameters and amendments to required portfolio allocations
- Assist the regulator in evaluating off-shore asset classes for pension-fund investment to address any shortage of domestic financial instruments
- Assist in the formation of an association of pension fund asset managers to represent industry interests

Task 2.B. Support development of the insurance industry (property and casualty, life, disability and health)

Objective: Develop the industry so it provides a broader array of private-sector life and non-life products; increase the industry's premium income and grow domestic investment capacity; foster the capability to offer annuities to pension funds.

Description: The first insurance product developed in most emerging markets is car insurance, because most countries require divers to have it; property insurance and health insurance follow. Life insurance, which provides the most significant source of long-term capital investment, is usually the last to develop, primarily because it is seen as a discretionary expense few can afford and insurance companies are reluctant to develop it without ongoing actuarial analysis. Given the fiduciary nature of the business, insurance supervisors have significant discretion in how an insurance company operates and invests its money.

Sub-Task 2.B.1. Support development of actuaries

Objective: A cadre of professionally certified actuaries who can measure risk in the design and application of insurance products, contributing to the growth of sound financial analysis, especially as it applies to life insurance. Development of such professionals is equally important to the management of pension assets.

Description: Measuring and managing risk is at the core of the insurance industry. The process involves detailed mathematical analysis of numerous variables to quantify risk. Risks must be classified and subsequently priced in the premiums charged for insurance products. Actuaries are trained to conduct such specific analysis; they are vital to development of the insurance industry. Accordingly, the contractor will:

- Develop a certification course in cooperation with the International Actuarial Association (IAA); identify candidates interested in becoming actuaries
- Offer certification course work in accordance with international standards
- Form a society of actuaries affiliated with the international certification body
- Assist the society in becoming sustainable (e.g., through membership and activities)
- Promote the use of professional actuaries in the financial-services industry and government

Sub-Task 2.B.2. Support insurance supervision

Objective: An insurance supervisor who understands risk and how it is being managed, what factors affect capital adequacy, and what constitutes appropriate investment of assets; provides consumer protection, licenses professionals (e.g., insurance brokers and actuaries), and enforces penalties for violations

Description: It is in the industry's interest to establish an efficient system for monitoring and supervising the insurance companies and related professionals who meet the standards and requirements for full membership in the International Association of Insurance Supervisors (IAIS).

Accordingly, the contractor will:

- Conduct a critical review of supervision and control procedures exercised by each of the insurance supervisor's departments. The contractor will review the supervision manuals, the monitoring system, and surveillance procedures the insurance supervisor undertakes to assess the effectiveness of the existing system.

Based on this critical review, the contractor will work closely with officials and staff from the insurance supervisor's office to prepare a framework for developing the system. The contractor will need thorough buy-in from the insurance supervisor to successfully implement this framework. The contractor will work with the insurance supervisor to:

- Improve supervision procedures to better monitor the financial conditions of insurance companies and ensure their solvency
- Improve the manuals and examination procedures (e.g., rewrite weak sections, redesign procedures)
- Improve the insurance supervisor's analytical methods for monitoring insurance companies and related professionals' activities, such as brokers and actuaries
- Recommend the most effective and practical system for periodic financial examination of insurers and financial examiners' professional qualifications
- Establish an actuarial unit within the insurance supervisor that is capable of developing actuarial tables and providing other support needed to develop annuities and other life insurance products
- Create effective rules to regulate insurance companies' relationships with foreign reinsurers
- Reform the regulations that directly affect the insurance supervisor's supervisory role and suggest ways to adequately enforce those regulations
- Identify training opportunities and exchanges abroad. This training may be provided to the insurance supervisor's staff upon approval of the COTR.

The contractor should also conduct a training needs assessment (TNA) for the insurance supervisor's examiners and then design training courses and deliver them to relevant staff to upgrade their skills, capabilities, and analytical expertise. Training may include courses on software packages acquired by the contractor.

Sub-Task 2.B.3. Support regulatory reform

Objective: Improve supervision of the insurance sector through reform of existing rules and regulations.

Description: There will be a need to reform the rules and regulations governing insurance and improve supervision of the insurance sector. To determine what areas need improvement, the contractor will review and assess existing rules and regulations, and compare them with international regulations. Based on this review, the contractor will help the insurance supervisor's officials and staff identify the areas that need revision to achieve a competitive and efficient insurance market. The contractor will work with the insurance supervisor to:

- Set up control and monitor trade practices, advertising, and sales materials that protect consumers
- Establish requirements for disclosure of insurance policy information to consumers, both at the time of sale and after
- Determine how the insurance supervisor can best monitor the conduct of intermediaries, taking into account such aspects as prohibited practices, investigation of complaints against intermediaries, and disciplinary measures
- Establish effective dispute resolution between insurance companies
- Establish rules for licensing brokers, actuaries, and related professionals, including designing and establishing certification exams
- Allow both local and foreign insurance and reinsurance brokers to participate equally in the market
- Set capital requirements, qualifications, professional indemnity, and handling of clients' accounts and brokers' books and records in the insurance law
- Empower the insurance supervisor to direct and withdraw authorization and declare bankruptcy if in the public interest
- Set tariffs and taxes for different insurance activities
- Draft insurance laws, regulations, and decrees

Sub-Task 2.B.4. Develop Annuities

Objective: Enable the insurance industry to offer annuities for investment by pension fund recipients to manage payout obligations.

Description: An annuities market is an important adjunct to a Pillar II pension system. Development of such a market is dependent upon individual accumulations reaching a minimum investment size to justify a company's investment in product development. Furthermore, the investment in such a product is a bet by the recipient against living too long. Consequently, the actuarial computations are quite complex and must be calibrated to ensure that the company makes money. Accordingly, the contractor will:

- Undertake an analysis using actuarial principles to determine the minimum investment needed to support development of an annuities industry

If findings do not support development:

- Determine what conditions are necessary for development

If findings conclude development is possible:

- Examine product pricing techniques

- Examine corporate and investment supervisory investment policies and the procedures used to value assets
- Examine transaction costs
- Prepare a public-information campaign

Component 3: Issuance of Pilot Corporate Bonds

Task 3.A: Develop capacity for issuance of mortgage-backed bonds

Objective: Allow mortgage lenders to refinance or “liquefy” their mortgages by pledging them as collateral for mortgage-backed securities or for loans from a mortgage liquidity facility in the host country.

Description: The capacity to issue and place mortgage bonds depends upon on factors that affect their attractiveness to investors. Foremost is the legal basis that exempts mortgage collateral from bankruptcy. Second is the structure of the bond, which can employ features such as overcollateralization and the requirement to replace a bad mortgage with one that is performing to minimize risk. Preparations for issuance are complex and involve much handholding with participants. However, once institutionalized, a significant number of low-risk fixed-income products become available for investment by pensions funds, insurance, and mutual funds. These bonds are a way for asset managers to diversify portfolios away from an overconcentration in government securities and earn increased returns.

Sub-Task 3.A.1. Preparation for mortgage bond issuance

The contractor will explore mechanisms for securitizing mortgages. The contractor will evaluate the pricing of the cash flows generated by the mortgages and the management of subsequent liquidity risks and interest-rate risks. The contractor will also analyze different approaches to securitization, including MBSs; mortgage pass-through securities; outright loan sales to institutional investors; loan portfolio guarantees; bond guarantees; and bonds secured by assets including, but not limited to, mortgages. Each option requires substantial work to ensure reliability of these instruments, including enactment of new laws and regulations.

When any of the commercial banks that have participated in the CML Program have a minimum of $10 million in their mortgage portfolio, the contractor will assist the bank in structuring and issuing an MBS. Selection of the commercial bank/s for MBS pilot issues will be subject to the written approval of the COTR. The contractor will evaluate accurate pricing of the cash flows generated by the mortgages and the management of subsequent liquidity risks and interest rates risks. The contractor will also analyze the cost/benefits of credit enhancements, such as USAID’s DCA, loan portfolio guarantees, or other guarantees.

Accordingly, in preparation for mortgage securities issuance, the contractor will:

- Analyze and devise a methodology profile for schemes of mortgage securities issuance by mortgage originators; then make a comparative analysis of the different alternatives and suggest the most workable scheme
- Draft instructions and regulations specifying rules and procedures of mortgage securities issuance and circulation
- Prepare a methodological profile of economic criteria used for analysis of mortgage securities
- Devise a mechanism and system of guarantees that ensures reliability of mortgage securities
- Draft legislative acts, as required, to identify specific operational features of mortgage banks
- Demonstrate the reliability and security of mortgage securities
- Draft required regulations and instructions
- Design a program of actions to stimulate domestic institutional investor interest and foreign investors' interest in the mortgage securities market
- Devise a methodological profile of mortgage insurance, including individual, property, and title insurance
- Establish methods and terms of mortgage-risk insurance
- Devise a unified methodology for appraising property that is being mortgaged
- Develop a database of real estate transactions and prices
- Analyze and devise a methodology profile for schemes of mortgage securities issuance by mortgage originators; then make a comparative analysis of the different alternatives and suggest the most workable scheme
- Deliver proposals regarding amendments to current legislation and regulations that would be constructive to the issuance and circulation of mortgage securities in the host country
- Draft instructions and regulations specifying rules and procedures

Sub-Task 3.A.2. Pilot Issues

Objective: Prepare corporate management for the issuance process and the successful placement of its bonds. After the pilot issue is complete, the process will become sustainable and not need continued intervention. The contractor will assist in preparing a bond for issuance by advising on:

- Preparation of the corporate resolution authorizing the borrowing
- Determination of use of proceeds
- Review of audited financials (preferably IFRS)
- Setting financial parameters, including the maturity
- Selection of a BD/financial advisor
- Selection of a legal advisor to assist with preparation of a legal opinion
- Rating the issue
- Registration with securities market regulator
- Preparation of investment memorandum
- Investor meetings/presentations
- Stock exchange listing and sale

Sub-Task 3.A.3. Development of ratings capacity

Objective: To the extent possible and with assistance from the leading international credit rating agencies, encourage and facilitate the establishment of independent rating agencies.

Description: Information is the lifeblood of international investing. An assigned rating is based on third-party scrutiny of the company, its management, and its financial systems. After the review, the third party issues an opinion regarding the company's ability to repay its debt. The process of obtaining a rating instills discipline in financial reporting and establishes rigorous disclosure comprising understandable, standardized information. To develop such analytic capacity, such a rating agency will:

- Introduce issuer rating methodology and criteria
- Introduce rules and procedures for assigning credit ratings to mortgage securities
- Introduce certification methods for mortgage loan products offered by bank and non-bank securities issuers
- Perform the credit-rating analysis and assign rating scores to specific issuers and the securities the issue
- Introduce national scale ratings that analyze the likelihood of default compared with similar companies in the country

Sub-Task 3.A.4. Legal and regulatory reform

Objective: Put in place all necessary laws and regulations that support corporate bond issuance, mortgage-covered bond issuance, and, if appropriate, a law on securitization.

Description: Nearly all emerging economies will need second-generation legal reforms (e.g., a viable pledge law enabling the pledge of assets to multiple pledges and new bankruptcy regulations that exclude pledged assets from the general liquidation assets of bankrupt entities). A perfected trust law would also increase transparency and facilitate broader issuance of ABSs. The contractor's legal and regulatory reform efforts should be limited to those areas directly related to the pilot issue of corporate bonds. Specifically, the contractor should:

- Ensure the law "On Pledge" allows multiple pledgeholders and aggregate (or master) pledge
- Ensure the law does not preclude registration of moveable pledge
- Ensure the law allows the pledge agreement to be signed by a representative of the pledgeholder
- Ensure the law "On Bankruptcy" (or the statutes of the civil code governing bankruptcy procedure) requires creditors' claims to be settled before shareholders may recover any proceeds from bankruptcy estate
- Continue institutional capacity-building of the financial markets' regulators, focusing on transparency and disclosure in bond-related regulation for the securities commission
- Assist the securities commission in the development of a modern financial disclosure system

- Draft regulations governing investment advisors and rating agencies
- Seek broader investigative powers for better enforcement
- Amend pledge and bankruptcy laws with draft legislation that enables the use of trusts
- Draft a covered bond law and its implementing regulations once the law is enacted