FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE –
DEVELOPMENT MODULE

EL SALVADOR

CAPITAL MARKETS

TECHNICAL NOTE

NOVEMBER 2016

This Technical Note was prepared in the context of a World Bank Financial Sector Assessment Program mission in the Republic of El Salvador in March 2016 led by John Pollner and overseen by Finance and Markets Global Practice, World Bank. The document contains technical analysis and detailed information underpinning the FSAP assessment’s findings and recommendations. Further information on the FSAP program can be found at www.worldbank.org/fsap.
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I. Market Overview

1. The capital markets in El Salvador continue to remain relatively small but have played a larger role in financing real sector needs in the last 5 years. Nongovernment bonds outstanding increased by 75% since 2011 amounting to US$ 1.5 bn \(^2\) in 2015 or about 5.8% of GDP, which is still below that of some of its peers as well as the regional median (10.8%) (Figure 3). The recent increase is driven by a steady growth in securitizations, which represented 49% of total nongovernment bonds outstanding (Figure 1). Securitization issuers come from diverse sectors unlike other debt issuers, with proceeds being used to finance infrastructure projects as well as municipalities, among others. Equity market capitalization remained relatively steady over the last 5 years, representing about 41% of GDP in 2015. Despite this relatively high capitalization, the equity market is not being used for the purpose of raising capital but rather to satisfy a legal requirement for all financial institutions to list on the local market. Government debt securities outstanding stood at US$ 10.8 bn. as of 2015, 41.5% of GDP, more than half of which was represented by issuance in Eurobonds (Figure 2).

2. The investor base is dominated by institutional investors. Two pension funds represent the primary investors in the securities market, followed by banks and insurance companies. An Investment Funds Law was approved in 2014 and related regulations are expected to be enacted in 2016, which will allow establishment of a new investor in the market in the form of investment funds. Retail investors, while representing a significant level of assets

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\(^1\) This Technical Note was prepared by Tamuna Loladze, Securities Market Specialist, in the context of a World Bank Financial Sector Assessment Program mission in El Salvador during March 2016 led by John Pollner, World Bank and overseen by Finance & Markets Global Practice, World Bank. The note contains technical analysis and detailed information underpinning the FSAP assessment’s findings and recommendations. Further information on the FSAP program can be found at www.worldbank.org/fsap

\(^2\) The outstanding amounts in the last 5 years exclude issuances by several public institutions, such as the Development Bank of El Salvador (Bandesal), which, for example, amounted to an additional US$ 244 mn. in 2015.
in 2000s through *carteras collectivas* currently play a marginal role, although, their presence is expected to increase with the entry of investment funds. Foreign investor participation is facilitated by the recent reduction of the foreign investor tax from 20% to 3%.

![Figure 3: Securities markets in peer countries](image)

**Figure 3: Securities markets in peer countries**

<table>
<thead>
<tr>
<th>Country</th>
<th>Stock market capitalization / GDP (%)</th>
<th>Outstanding government debt securities / GDP (%)</th>
<th>Outstanding nongovernment debt securities / GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>El Salvador</td>
<td>5.8%</td>
<td>8.2%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>8.2%</td>
<td>10.8%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Guatemala</td>
<td>7.2%</td>
<td>0.0%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Peru</td>
<td>0.90%</td>
<td>5.8%</td>
<td>16.4%</td>
</tr>
<tr>
<td>Colombia</td>
<td>5.8%</td>
<td>10.0%</td>
<td>15.0%</td>
</tr>
<tr>
<td>Mexico</td>
<td>16.4%</td>
<td>10.0%</td>
<td>20.0%</td>
</tr>
<tr>
<td>Regional Median</td>
<td>0.0%</td>
<td>10.0%</td>
<td>15.0%</td>
</tr>
</tbody>
</table>


3. **The integration with Panama is a welcome development and will help improve opportunities for Salvadoran investors and issuers.** The supervisors, stock exchanges and central securities depositaries of El Salvador and Panama signed an agreement in September 2015 to integrate their markets via a remote operators model. The latter entails allowing a home country broker to directly purchase a host country’s securities without needing to go through a host country broker. The authorities are in the process of reviewing all relevant arrangements (e.g., broker, trading, clearing and settlement) to operationalize the integration.

4. **The regulation and supervision of capital markets is shared, respectively, between the Central Bank (BCR) and the Financial Superintendency (SSF) and this required stronger coordination.** The BCR is responsible for developing all regulations related to the financial sector, while the SSF is in charge of all financial sector supervision. This division of responsibilities requires strong coordination between the two institutions, which has not always been optimal, and has affected the efficient development and implementation of financial sector and capital market reforms. There is regular dialogue between the two institutions and regulations are usually developed with inputs from both authorities – this process should continue to be coordinated productively.
II. MARKET SEGMENTS

A. Government Debt Market

5. **The Central Government is the main issuer of debt securities**, which it does through the Ministry of Finance (Ministerio de Hacienda, MH). The Central Bank (Banco Central de Reserva, BCR) also has the ability to issue debt and has done so in the past but not recently. Given the country’s dollarized economy, it does not do so for monetary policy purposes but rather for ad-hoc financing needs. Judging by the current outstanding BCR securities, it also appears that there was no coordination of maturities between the two institutions, with BCR issuances spanning the maturity spectrum. The Central Government debt outstanding stood at US$ 10.8 bn as of 2015 and has seen a gradual increase in the last 5 years from 30.6% of GDP in 2011 to 41.5% of GDP in 2015.

6. **The government debt market is underdeveloped and characterized by ad-hoc issuances with the majority of debt issued in the international market.** Over 50% of the Central Government debt outstanding is in Eurobonds, followed by domestic securities issued to pay for a pension deficit (*Certificados de Inversion Previsional*, CIPs),

3 and domestic treasury bills (Letes) and bonds, which make up a much smaller proportion of the outstanding debt (Figure 4). If the CIPs are excluded, the Eurobond share of the total debt increases to 77% (Figure 5). The MH does not have an issuance strategy in place and only issues Letes on a regular basis in large part due to the legal constraints it faces for longer term issuances (see below). The Letes auctions take place roughly twice a month for amounts of approximately US$ 50-60 mn per month. While the Exchange is informed before the start of a month about the number of auctions and amount of Letes the MH plans to issue that month, the investors are notified only 3 days before the auction.4 All debt sales are conducted through multiple-price auctions (direct placements have been very rare). There are no primary dealers.

7. **The Ministry of Finance faces legal restrictions in its ability to issue debt instruments of more than 1-year maturity and properly manage its debt portfolio.** Article 97 of the Organic Law of the State’s Financial Administration (AFI) requires the government to obtain approval of the National Assembly to carry out any debt issuance (domestic or international) with medium or long-term maturities. Moreover, the Budget Law (Ley de Presupuesto) issued every year prohibits the MH to issue debt for an amount greater than 30% of the government’s current revenue. A National Assembly approval is also needed to perform any

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3 This deficit is associated with an old pension system that applies to a certain portion of the population. The CIPs securities are issued at a very low rate and purchased by the two private pension funds, which are obligated to buy them.

4 Although, the MH sometimes checks the appetite of principal investors (e.g., banks) through phone calls ahead of scheduling auctions.
8. **The lack of strategic government issuance has resulted in a yield curve concentrated in short- and long-term maturities** (Figures 6 and 7). Given the existing legal restrictions, the MH issuance has been focused on Letes and less frequently Eurobonds (following a National Assembly approval), which are often issued to pay off accumulated Letes liabilities. Most issuances are either longer than 10 years or less than 1 year, as a result of which, the government bond yield curve has very few references in the medium-term segment. The government also faces a high refinancing risk with large amounts of interest and amortization payments coming up in the next 10 years. This, coupled with the government’s inability to perform liability management operations, is another reason why issuing more medium-term debt at this stage would not be feasible. The limited medium-term issuance, coupled with the lack of secondary market trading, constrains the ability to price private debt securities, which tend to use government issuances as a reference, since many of them target 2-7 year maturities.

9. **The investor base for government debt securities is dominated by banks for short-term securities and pension funds and international investors for long-term issuances.** Pension funds currently hold 14% of MH securities, not counting mandatory investments in CIPs. Foreign investors are important participants in the government’s Eurobond issuances, usually purchasing about 75% of an issuance, with the rest reserved for domestic investors.\(^6\) In

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\(^5\) This is apparently due to capacity constraints among Assembly members, many of whom are not well informed about financial sector issues.

\(^6\) Based on the last Eurobond issuance, which is considered representative.
fact, the MH prefers to issue Eurobonds as opposed to domestic bonds in large part because of its scale requirements and the small absorption capacity of the local investor base – about US$ 200-300 mn a year. Banks are the primary buyers of Letes, while insurance companies are active in all maturities.

10. **Secondary market trading in government securities has been limited and further declined in the last two years.** Secondary market activity is extremely shallow in the Salvadoran market, including in the government bond market. Most investors prefer to hold instruments to maturity, considering scarcity of investment opportunities. The trading has further decreased in the last few years (Figure 8), in part likely due to the adoption of the financial transactions tax at the end of 2014 with the enactment of Ley de Impuesto a las Operaciones Financieras (LIOF). The tax is applied as a flat 0.25% on the amount of the financial transaction, paid by the transferor of funds. Repo securities, the majority of which (91%) use public debt securities as collateral, dominate all secondary market trading in El Salvador, accounting for 92% in 2015 (Figure 9). The financial transactions tax also applies to repos, but it is annualized,\(^7\) whereas for all other securities, including short-term, it is not.

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\(^7\) For example, for repos with maturity of 7 days, a 7-day rate would be calculated based on an annual tax rate of 0.25%.
B. Nongovernment Debt Market

11. The nongovernment bond market has seen relative growth in the last 5 years, fueled by securitization issuances, but corporate issuance remains limited and concentrated in the financial sector. (Figure 1). Nongovernment bonds outstanding outside of securitizations remained relatively steady around US$ 800 mn except for a rise to about US$ 1 bn in 2014.\footnote{These figures exclude issuances by several public institutions, such as the Development Bank of El Salvador (Bandesal), which amounted to an additional US$ 244 mn in 2015, for example.} The issuance in this segment is dominated by financial institutions – only 1 out of 12 issuers is from the real sector (electricity). Several factors serve as a disincentive for non-financial companies to issue debt. First, many companies are well served by the banking sector, not only domestic but also regional, as companies get competitive offers on credit products from banks in other Central American countries once they reach a certain scale. Second, the involved and often long issuance process (see below) seems as a more complicated and costly option compared to financing from banks or from international capital markets, with at least one well-established company electing to go this route. Finally, many companies are family owned business and are reluctant to share widely their proprietary confidential information.

12. Securitizations have seen steady growth and are financing real sector needs, including infrastructure. The market has embraced securitizations since the passage of the Securitization Law in 2007 and related regulations in 2009, with securitization issuances steadily growing over the last 6 years (Figure 10), reaching US$ 748 mn or about 2.9% of GDP by the end of 2015, which represents 49% of total nongovernment bonds outstanding. There is a much greater diversity in the issuers of securitizations than of other debt instruments (Figure 11): 15 issuers to date include municipalities, a university, a hotel, a restaurant franchise, and several infrastructure related issuers (e.g., airport, roads, energy, and water), among others, some of
which have issued more than once. Infrastructure represents 65% of all securitization issuances if considering only discrete infrastructure issuers/projects; this share is likely higher once factoring in securitizations by municipalities, many of which use the proceeds for infrastructure projects. The pipeline of securitization issuances, estimated at US$ 400 mn,⁹ is also concentrated in the infrastructure sector, comprised mainly of public infrastructure projects but also a few potential issuances from other Central American countries that see opportunities of better interest rates and longer maturities in the Salvadoran market.

Figure 10: Securitizations Outstanding (US$ mn)

13. **The regulatory framework for securitizations is considered fairly robust but some structures used entail greater risks than traditional securitizations and require careful analysis.** Securitizations in El Salvador are issued through a fund established by a securitization company for each securitization issuance, which serves as a special purpose vehicle to receive the securitized flows of underlying assets. However, the majority of securitizations in El Salvador are whole business securitizations (WBS), that is, securitizations of specific future revenue flows received by the originating institution, where the generation of the revenues depends on the originator continuing to operate as a going concern business. This is unlike traditional securitizations, where the cash flows from underlying assets are independent of the well-being of the originating company. While the cash flows in Salvadoran WBS are carved out and isolated, usually with a mechanism to directly transfer them to a designated securitization fund, they are not completely bankruptcy remote like with traditional securitizations. This requires careful analysis by investors, as well as by the Financial Sector Superintendency (Superintendencia del Sector Financiero, SSF) of the financial situation of the originator at the time of issuance, although, the regulation only requires the review of financial statements of the issuer, which technically is the securitization fund.

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⁹ According to estimates by Hencorp, the larger of the two securitization companies.
14. **Primary investors in securitizations are local pension funds.** Unlike pension funds in many other Latin American countries that tend to be rather conservative, Salvadoran pension funds have the adequate capacity to analyze securitization instruments, including those related to infrastructure issuances, and are keen to invest in them, considering the dearth of investment opportunities outside of the government sector. The two pension funds could only invest in up to 70% of an issuance (35% each), but this recently increased to 100% (50% each). There is a legal requirement to place a minimum of 75% of the authorized amount for a securitization within 6 months of obtaining issuance authorization from the SSF; in case of a failure to do so, the entire issuance, including already placed amount needs to be unwound. This means that if the maximum investment amount cannot be secured from the two pension funds, the securitization company must seek other investors to try to place at least 75% of the issuance amount. To attract other local investors, such as banks and insurance companies, which, in El Salvador do not have an appetite for long-term investments, securitization companies have had to tailor to their needs by structuring separate tranches with shorter maturities (e.g., 5-7 years), whereas tranches targeting pension funds usually have maturities of 12-15 years.

15. **With the uncertainties related to the pension reform proposal, foreign investors, especially from the region, are increasingly being sought for upcoming securitizations.** The
current pension reform under consideration,\textsuperscript{10} which could nationalize around 60% of private pension assets, creates significant uncertainties for the two pension funds and has, as a result, dampened their appetite for investments, especially in less conventional instruments, such as securitizations. This was, for example, the case with a recent securitization of a public water company, ANDA, in which one pension fund purchased a relatively small amount of the issuance, whereas the other did not participate at all. Given these developments, securitization companies are starting to prospect foreign investors from the Central American region to purchase Salvadoran securitizations (see section on Regionalization).

16. The infrastructure sector, while being able to take advantage of the securitization framework, faces limitations in using the public-private partnership (PPP) structure due to constraints in the PPP law. PPP projects are required to obtain approval from the Legislative Assembly at two different stages in the process: at the project proposal stage and just before implementation. This creates significant risks to parties involved in a PPP project, including finance providers (e.g., banks, investors), that the project may not materialize. In addition, certain thresholds specified in the law for minimum project size and maximum investment by government agencies could preclude larger projects from using the PPP structure.

17. Outside of securitizations, there are two main instruments that can be used to issue nongovernment debt securities but with some overlapping characteristics that confuse the value of each. Certificado de Inversion (CI) is a longer-term instrument and could have maturities of up to 10 years, but theoretically is not prohibited from having a short-term tenor. Papel Bursatil (PB) is a short-term instrument with a maturity of up to 3 years, but most have been up to the 2 year maturity range and these can be issued with or without underlying collateral guarantees. The CI has a placement period of 2 years, whereas the PB of 11 years. There is no traditional commercial paper instrument that is focused on maturities of up to 1 year.

18. Maturities are concentrated in the 5-8 year range for corporate issuances and 10-15 year range for securitizations. The longest maturity has been for 18 years for the airport securitization (CEPA). Although, if considering issuances by state-owned enterprises, such as, for example, Social Fund for Housing,\textsuperscript{11} maturities extend to 25-30 years.

19. Credit ratings issued by local credit rating agencies are mandatory and are usually obtained targeting pension funds as final investors. Pension funds can only purchase securities that have two local credit ratings with a minimum rating of A. Thus, although, issuance regulations only require one credit rating for nongovernment issuances, most issuers obtain two to make their securities eligible for purchase by pension funds. They also seek a rating at least one notch higher than A to allow for possible downgrades and avoid a mandatory sell-off by pension funds, should a rating dip below A. Nevertheless, there have been several issuances with

\textsuperscript{10} This issue is discussed in greater detail in the Aide-Memoire FSAP report to the authorities.

\textsuperscript{11} Fondo Social para la Vivienda.
lower credit ratings – as low as BBB- – which have successfully placed their bonds with non-pension fund investors.\textsuperscript{12}

20. **The nongovernment bond market in El Salvador exhibits very low liquidity.** With limited issuance volumes and low market depth, most issuances are quickly bought up by buy-and-hold investors always on the look-out for investment opportunities outside of the government sector. It is important to note that, in general, nongovernment bond markets are not very liquid instruments even in more advanced markets due to their specific characteristics, such as lack of fungibility, low issuance amounts, more complex and higher-risk structures, and prevalence of buy-and-hold investors. But, over time, as the market grows and exhibits more frequent issuances and larger issuance amounts, one could expect liquidity to also increase in relative terms.

21. **An incomplete benchmark government yield curve with limited references in the medium-term complicates pricing of nongovernment debt instruments.** Many nongovernment issuers target the 2-7 year maturities, but this is the segment where the government bond yield curve is underdeveloped, with only limited references. As a result, prices for nongovernment instruments are often extrapolated from T-bills or sometimes Eurobonds. There are also no dedicated price vendors in El Salvador; however, draft regulations to establish price vendors and valuation of securities based on international practices and the International Financial Reporting Standards (IFRS) have been developed\textsuperscript{13} and will be approved in the third quarter 2016. The regulations will initially apply only to investment funds, soon expected to enter the market, due to the specific legal and regulatory context applicable to various financial institutions: namely, banks, insurance companies, and brokers are not yet subject to and will be required to adopt the IFRS within 2-3 years, while pension funds are required by law to rely on a valuation methodology provided by the SSF.

### C. Equity Market

22. **The equity market remains relatively underdeveloped and not used for economic purposes of raising capital.** The equity market capitalization remained relatively steady over the last 5 years, amounting to US$ 10.75 bn in 2015 or about 41\% of GDP, with the number of listed companies increasing marginally from 44 in 2011 to 50 in 2015 (Table 1). However, despite this relatively high market capitalization, the equity market exists primarily because of the legal requirement for all financial institutions to list their shares on the local market. As a result, out of 50 listed companies, only 4 are from the real sector (electricity and telecom). Thus, the equity market is not being used as a way to raise capital but merely to comply with a legal obligation. There is no minimum float requirement and secondary market trading is virtually non-existent.

\textsuperscript{12} These include CrediQ, CrediComer, and Banco de Fomento Agropecuario.

\textsuperscript{13} With support of the WB FIRST funded bond market development project.
Challenges to attracting more equity issuers relate to the lack of equity culture, structural challenges, and issuance requirements and processes. In general, there is a lack of equity culture in El Salvador, as is typical for most Latin American countries, with the economic activity dominated by small family-owned businesses who are reluctant to give up ownership and reveal proprietary information. Issuance requirements and prolonged and uncertain approval process (see below) serve as a disincentive for many smaller and less formal companies. Some requirements seem completely irrelevant for equity issuers and unnecessarily increase costs, such as for example the requirement to obtain a credit rating.

<table>
<thead>
<tr>
<th>Table 1. Equity Market Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
</tr>
<tr>
<td>Market capitalization (US$ mn)</td>
</tr>
<tr>
<td>Market capitalization (% of GDP)</td>
</tr>
<tr>
<td>Number of listed companies</td>
</tr>
<tr>
<td>Number of new listings</td>
</tr>
</tbody>
</table>

III. REGULATORY FRAMEWORK FOR ISSUANCE OF SECURITIES

The modification of the Securities Market Law in late 2014 introduced a number of improvements to the securities authorization process. The public offer issuance process, which used to entail an issuance application first going to the Exchange for review and approval and then to the Financial Superintendency (SSF), was reversed, with the SSF now playing an initial and more central role in the approval process. The same legal modification introduced a deadline of 15 working days for the SSF to approve a securities issuance, which, in general, is a move in the right direction, although, may have been a bit premature until the SSF is able to implement efficiencies and improvements in its internal systems, processes, and capacity (see below). Finally, the legal modification assigned explicit responsibility to brokers for ensuring that issuers whom they advise and represent comply with all their requirements and obligations. The ultimate responsibility for ensuring that the information is true, accurate, and complete rests with the issuer.

The securities authorization process lacks efficiency, despite some efforts to implement improvements, and represents a major bottleneck to attracting more issuances to the market. The challenges can be divided into two parts: issuance requirements and the review and approval process carried out by the SSF, which has, at times, taken up to 6-8 months by anecdotal accounts. In terms of issuance requirements, among others, issuers are required to provide projections of the capacity to make debt payments over the life of the security and a detailed report about the target market for their issuance. These types of requirements, in general,
are not standard international practice\textsuperscript{14} and are considered overly burdensome and largely unnecessary, especially for established entities like financial institutions, which comprise the bulk of existing and recurrent issuers.

The approval process faces the following main challenges:

- The Superintendency leans towards a merit approval approach, whereby through its thorough review of all required documentation, it strives to ensure the issuer’s credit quality and capacity to pay (by analyzing their projections), as opposed to solely focusing on ensuring adequate disclosure of all pertinent information, especially of relevant risks. In general, assuming the role of implicitly providing a stamp of approval on issuances raises significant reputational risks for the supervisor and should be avoided. The SSF’s thorough review of issuance documentation could be, in part, a result of the SSF being an integrated regulator\textsuperscript{15} and having within its competency the supervision of financial institutions, as part of which it needs to ascertain their solvency. But this function clearly rests with the banking supervision department and should not be confused with the role of the securities supervision. The other reason for its thorough review is the SSF’s experience of receiving poorly prepared documents, which potentially point to the lack of responsibility and/or insufficient capacity of brokerage firms\textsuperscript{16} to conduct proper due diligence, as well as inadequate enforcement by the supervisor. Finally, there is a heightened concern about money laundering and financing of illicit activities (drug trafficking, terrorism) in El Salvador, as well as in the rest of the region, and this also contributes to the SSF’s desire to prevent any “bad” issuers from entering the market.\textsuperscript{17}

- There is a concern that intermediaries involved in the securities issuance process are not performing their functions adequately, which raises concerns with the SSF about the quality of work produced by these intermediaries. In addition to brokerage houses, whose due diligence practices have been questionable, as mentioned above, some credit rating agencies also reportedly exhibit low competencies, as a result of which, in reality there could be differences in the credit quality of issuers that receive the same credit rating by different rating agencies.

- Banking issuers, at least 30 days prior to presenting an issuance application to the Securities Superintendency, must submit issuance information (including the projections, market report, and intended use of proceeds) to the Banking Superintendency, which has to issue a “no objection” to the issuance; this further complicates and can significantly delay the issuance authorization.

\textsuperscript{14} Though, for example, Costa Rica requires financial projections for newly formed entities (e.g., project companies or trusts) that do not have a 2-year financial history.

\textsuperscript{15} Within the SSF, there are divisions between different segments of the market – Securities Superintendency, Banking Superintendency, Pensions Superintendency, etc.

\textsuperscript{16} All issuers must go through brokerage firms, who are responsible for submitting all required documents to the Superintendency on behalf of the issuer.

\textsuperscript{17} The SSF has reportedly stopped two drug cartel operations from entering the securities market.
• While the SSF, as of 2014, is required by law to approve all issuances within 15 working days, the involved process that inevitably spans much longer than this time frame had prompted the authority to institute a “previous review” process that would not begin the countdown of the 15 days. The “previous review” was done using a system for electronic document submission, DOCUVAL, which did introduce important efficiencies; however, the process was voluntary and often caused more work and confusion on the part of the issuer. Moreover, because DOCUVAL was taking place outside of the 15 day period, the SSF had the luxury of conducting an extensive review and going back to the issuer and its advisers with multiple comments, a process that, in effect, significantly lengthened the total authorization period. DOCUVAL is now being discontinued and the Superintendency is working on implementing other efficiency measures to ensure their compliance with the 15 day requirement.

• With the discontinuation of DOCUVAL, the SSF is now going back to receiving all issuance related documents in physical form, which poses significant inefficiencies; for example, it could take up to 2 days to scan the received documentation. The SSF is working on implementing an institution-wide IT system that will facilitate electronic receipt of documents.

26. **The legal framework does not allow private offers, there is no regime for frequent issuers, and all securities must be listed on and placed through the local stock exchange, all of which limits the ways in which companies can access the securities market.** The Salvadoran issuance framework lacks any kind of fast track issuance regime for established companies that regularly access the market or for issuers that are not looking for a wide distribution of their securities among the investing public. Recurrent issuers are mentioned in the regulation for the registry of issuers and issuances, but there is virtually no difference in their requirements and the process of authorization compared to a first-time issuer. While there is some semblance of a program issuance within the issuance framework for the Papel Bursatil instrument, given the long placement period (11 years) and the ability to rollover the issuance up to the total amount authorized, this is a peculiar regime that tends to blend many elements together, on the one hand providing a very liberal framework but, on the other, incentivizing the market to only think in terms of short-term issuances.

27. **Ongoing supervision of issuers could benefit from a number of improvements related to the information collected on a continuous basis as well as the process of supervision.** For example, for securitizations, which have close linkages with originating institutions, as described above, submission of periodic financial statements is required for securitization funds, but not the originators. There is no specific regulation that states what types of events should be reported as part of material events except for an Instructivo issued by the Exchange that provides some orientation in this regard. There are also potentially inconsistent requirements for when material events should be reported: there is a general requirement of 3

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18 Article 12 of NRP-10 Normas Técnicas para la Autorización y Registro de Emisores y Emisiones de Valores de Oferta Pública.
days, but the Exchange’s *Instructivo* has different time frames outlined for different types of events, ranging from 3 to 30 days. In terms of the supervision process, the SSF has not developed a systematic process of reviewing ongoing disclosures, such as a list of key financial indicators they would analyze, review of material events and related press reports, and an automated system of alarms to flag a serious deterioration in an issuer’s position.

28. **Availability of foreign securities for purchase and trading in the local market is subject to cumbersome registration requirements, limiting investment opportunities for local investors.** The Securities Market Law requires that foreign securities be registered in the Superintendency and subsequently listed on the local exchange. This requires a brokerage firm that is interested in bringing the foreign securities to the market to translate foreign prospectuses and provide other documentation, a process that can be arduous and long. These requirements seem to confuse the difference between foreign securities intended for the primary market, where a foreign company is seeking to raise funds from Salvadoran investors in the local market, and foreign securities destined for the secondary market, where the issuer has already raised funds in a foreign market and its securities are simply made available in the Salvadoran market for investment and trading purposes. While, in the first case, it is warranted to impose registration requirements similar to those applicable to local issuers, in the second case, these present an unnecessary burden and limit investment opportunities for local investors, namely brokers acting on behalf of their clients and pension funds.

IV. **INVESTOR BASE**

A. Pension funds

29. **Pension funds are the largest and most important institutional investors in El Salvador.** Their assets under management (AUM) have been steadily growing at a rate of 7% CAGR over the last 5 years, reaching US$ 8.5 bn in 2015 or 33% of GDP (Figure 12), significantly above that of its peers and the regional median (Figure 14). The industry is comprised of two pension funds that roughly split the market between them and follow similar investment strategies. Both are owned by foreign financial groups – AFP Crecer is owned by the Colombian Grupo Sura and AFP Confia by the Honduran Grupo Atlantída.

30. **Pension funds are severely constrained in their ability to diversify their investment portfolios due to a number of legal and regulatory restrictions.** Pension funds are obligated to invest around 60% of their assets in government securities (*Certificados de Inversion*

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19 The same brokerage firm is then required to provide ongoing information to the market about these securities, an obligation that can lead to uncertainties if the brokerage firm exits the industry, which has been the case with a few brokerage firms recently.

20 Banks, insurance companies, and brokers acting for their own account are able to invest directly in the international markets.

21 Compound annual growth rate.
Previsional, CIPs) issued to help pay for the deficit of the public pension system.\textsuperscript{22} They are also required to invest only in securities that are registered locally, listed on the local exchange, with a minimum rating of A provided by two local credit rating agencies. This effectively allows them to invest only in securities of foreign companies that are consciously seeking a primary offering in the Salvadoran market, since internationally listed companies, even if registered by Salvadoran brokers on the local Exchange through the process described above, would not have two local ratings. These restrictions, coupled with a 10% portfolio limit on foreign investments, severely handicaps the pension funds’ ability to invest in international securities (see Table 2 for selected portfolio limits). As a result, with this limitation and facing a relatively short supply of securities in the local market, close to 80% of their portfolio is invested in government securities (Figure 13), significantly limiting their risk-return diversification and ability to earn adequate returns on behalf of their beneficiaries.\textsuperscript{23}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure12.png}
\caption{Institutional Investors (AUM as % of GDP)}
\end{figure}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure13.png}
\caption{Pension fund investments as of Jan 2016}
\end{figure}

Source: SSF.

Note:
1. There was no data available for insurance assets for 2014.
2. Portfolio administration is being phased out with the entry of investment funds.

\textsuperscript{22} See FSAP report section on Pensions for further details.
\textsuperscript{23} According to the Pension Superintendency, in the last 12 months, the real average return for the two pension funds was 0.58% while their average real accumulated return since inception was 7.5%.
Pension funds have the potential to play a significant role in financing strategic economic needs, such as infrastructure, but face serious challenges in light of the proposed pension reform. The two pension funds combined collect about US$ 500-600 mn per year from affiliate contributions and usually have roughly US$ 200-300 mn per year available for investment outside of mandatory investments in CIPs. So far this has served as a sufficient absorption capacity, given the amounts and the speed of availability of new instruments entering the local market; however, it could prove limited if the government were to develop large infrastructure projects that required significant financing from capital markets. In this regard,

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In addition to annual contributions from affiliates, this figure takes into account collection of interest and maturing principal, as well as payments for current pension obligations.

Though, pension funds have indicated that some portfolio rebalancing, primarily by selling government paper, could be possible if attractive investment opportunities were to arise.

The mission was made aware that the government has identified large infrastructure development needs but a clear pipeline is yet to be elaborated or is not yet available to the public.
the Salvadoran pension funds are quite keen on taking on infrastructure investments, unlike many pension funds in Latin America that tend to be more conservative; in fact, they from time to time have dialogues with the government to speed up development of infrastructure projects, where pension funds could play an important financing role – a type of “reverse roadshow.” Nevertheless, the current pension reform proposal to create a hybrid public-private pension system that would likely nationalize about 60% of private pension fund assets (the amount currently held in CIPs) is putting a damper on the pension funds’ appetite for investments, as they prefer to tread carefully during this uncertain period.

B. Other Institutional Investors

32. **Insurance companies play a relatively lesser role as capital market investors in the private sector and focus on shorter-term and more liquid instruments.** The insurance industry consists of 26 insurance companies and is characterized by high level of concentration and prevalence of financial conglomerates.\(^{27}\) Insurance company investable assets are significantly smaller than those of pension funds, only at 1.7% of GDP. Life insurance business has seen notable growth in the last 5 years and but represents only around 40% of insurance companies’ technical reserves.\(^ {28}\) As a result, insurance companies are not yet playing the role of typical long-term thinking investors as is common in many other markets but are rather focused on shorter-term and more liquid investments. A large portion of their assets is invested in bank term deposits (*Depositos a Plazo*), with some of the largest players having between 40-60% of their investments in these instruments, and government securities;\(^ {29}\) whereas only about 10% is invested in local non-government debt instruments (Figure 15); this is in part due to a shortage of available investment options. The restriction to invest only 10% in the same economic group was also mentioned as an important obstacle by some industry participants.

33. **Banks are important investors in the government debt market, especially in short-term maturities.** The banking industry had about US$ 1.1 bn invested in securities at the end of 2015 concentrated in short- and medium-term maturities with the maximum tenor typically going up to 7 years. Both banks and insurance companies consider the financial transactions tax as a large obstacle to investing in the securities market, given their need for liquidity.

34. **The mutual fund industry is in the process of formation and could play an important role in market development.** An Investment Funds Law was finally approved in 2014 after many years of being in the works and related regulations are expected to be approved in 2016, with 4 out of 15 approved so far. In the past, the market had developed a mutual funds-like product called *carteras collectivas*, managed by brokerage houses, which at its peak amounted to roughly US$ 700-800 mn in AUM. This points to a respectable size for a retail industry for the size of El Salvador’s market and bodes well for the potential to develop a mutual fund industry. The carteras collectivas have been gradually phased out, with only one brokerage

\(^{27}\) See the section of the FSAP report on Insurance for more details.


\(^{29}\) According to interviews with key industry members.
firm still administering this product with about 1500 clients and US$ 48 mn in assets, which it plans to transfer to the investment fund structure once in place. Overall, there is a significant interest to enter the mutual fund business, with many brokers analyzing the potential opportunity, but the issues of costs and sufficient investment freedom/diversification (see below) raise the question of how many investment funds the current market could sustainably support.

Figure 15: Insurance industry investments in 2014

![Figure 15: Insurance industry investments in 2014](image)

Draft investment fund regulations\textsuperscript{30} may not provide sufficient flexibility to allow these investors to bring in differentiated investment strategies to the current investor base. This relates in particular to liquidity and foreign investment requirements. The draft investment regulations require open-end investment funds to keep at least 20% of the fund’s assets in cash, bank deposits, or securities with high liquidity and low risk. To be considered liquid, securities need to meet a set of requirements, including maturities of under one year, ability to use as debt guarantees, available market pricing sources, and certain international and domestic credit rating requirements (\textit{presencia bursatil}).\textsuperscript{31} Given the characteristics of the Salvadoran market, with very low trading, some such requirements may be overly restrictive. In terms of foreign investments, investment funds would be required to only invest in foreign securities registered with the Superintendency and listed on the local exchange with the exception of investments in shares of other foreign open-end funds.\textsuperscript{32}

\textsuperscript{30} Dated July 31, 2015.
\textsuperscript{31} Obtained by dividing the number of days during which a security was traded by the total number of trading days operated by the exchange.
\textsuperscript{32} Note, this exception exists in the Law on Investment Funds (Art. 97) but the draft investment regulation (Art. 8) states that only foreign funds that are “recorded in the Register” are eligible for investment by domestic open-end funds. This is inconsistent with the exception provided in the law. In addition, Article 8 of the draft regulation states that these foreign funds need to comply with BCR regulations on commercialization of foreign investment funds, which is also in the process of being developed.
Foreign investors are important for the external government debt market but play a relatively limited role in the private securities market. As mentioned above, foreign investors play an important role in external government debt issuances but have a relatively low presence in the nongovernment segment. Nevertheless, with the uncertainty facing local pension funds, there may be an increased effort to attract the interest of foreign investors to strategic securitization issuances, especially in the infrastructure sector, with some already underway. Moreover, the presence of foreign investors will likely go up with the upcoming integration with Panama. The reduction in the foreign investor tax from 20% to 3% in November 2015 is an important positive change to facilitate this effort.

V. Market Intermediaries

The brokerage industry in El Salvador is facing relatively difficult times given the small size of the market. There are currently 11 brokerage houses registered in El Salvador, out of which one is an independent company with local ownership, two are part of international banking groups, and the rest are part of local financial conglomerates with presence in other Central American countries. Brokers can perform a number of services under a single license, including securities trading and structuring, registration of foreign securities, portfolio management, and investment for their own account. All secondary market transactions as well as primary market transactions related to non-government securities must be conducted through brokers – this includes retail and institutional investors; only primary market purchases involving government debt securities can be done directly by institutional investors without using a broker. Despite this arrangement, many brokers are having a relatively hard time keeping their businesses afloat, given low levels of activity, predominantly concentrated in repo transactions, and even further reduction in secondary market trading following the implementation of the financial transactions tax. This has prompted an exit of at least one broker from the industry and staff reductions in many others.

Conduct regulation and supervision for brokers related to offering of investment products to clients has improved in recent years but could be further strengthened. El Salvador recently adopted a regulation on the purchase and sale of securities, which includes requirements to profile clients according to their risk tolerance and develop investment policies according to different categories of clients, i.e., categorize investment products into distinct risk buckets as well. Draft regulation on market conduct, is being prepared. Some issues are worth noting in this regard:

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33 For example, for the ANDA water company securitization.
34 A comprehensive discussion of the issues and specific recommendations can be found in the report on “regulation and supervision of conduct of brokerage firms in their offering of services to clients” produced under the Bond Market Development project funded by the FIRST Initiative.
(i) The regulation suggests some guidelines for a questionnaire to be used to profile clients, but there are inconsistencies in how brokers develop and apply the questionnaire that could lead to different ways of profiling the same investor across brokerage firms;

(ii) There is a common practice of informing clients of the full spectrum of available investments, including those outside of their given risk profile; as a result, there are frequent occurrences of clients choosing investments outside of their registered risk profile by signing a letter releasing the brokerage firm from any responsibility;

(iii) The investment advice function is currently unregulated, though brokers provide recommendations and assume more responsibility than would be warranted under a pure order execution service.

39. **Securitization companies play a central role in identifying, evaluating, structuring, and bringing to market securitization issuances that have been driving primary market growth in recent years.** There are two securitization companies, with one having a clear dominant position responsible for bringing to market about 80% of securitization issuers, which accounts for around 75% of the securitization volume issued. They provide a comprehensive package of services and handle interactions with all the different market participants and regulatory-supervisory authorities involved in preparing an issuance – investors, credit rating agencies, brokerage firms, and SSF. They work particularly closely with the two pension funds that tend to significantly influence the terms of the deals, given their dominant position as the primary buyers of these instruments.

40. **The number of credit rating agencies (CRAs) may be too many for the size of the Salvadoran market.** There are currently five CRAs, out of which four are foreign owned and one is local. Two of the foreign firms hold 60% market share and are the most trusted for the quality of their ratings, with important players (e.g., pension funds) often dictating that they be used as opposed to others. Despite credit ratings being mandatory for debt issuances (with two ratings required if seeking pension fund investment), the market activity may still be too limited to support this many CRAs. Competition among the lower-ranked firms appears to be fierce, which has the effect of lowering standards and catering to an issuer’s desire to obtain a specific rating. The SSF is conscious of these practices and, as a result, tends to review rating agency reports with utter diligence as part of its review and approval process for a securities issuance, which can contribute to prolonging the process.

### VI. Market Infrastructure

41. **The stock exchange continues to have a monopoly on all transactions being executed in the securities markets, both in the primary and secondary markets.** Bolsa de Valores de El Salvador (BVES) is the only securities trading venue and non-exchange over-the-counter trading is not permitted. All securities are also required to be listed on the exchange, which does

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35 There is one international (Fitch), two Peruvian (Zumma Ratings and Pacific Credit Rating), and one Costa Rican (SC Riesgos).
not allow issuers the possibility to have a more limited distribution of their securities among institutional investors, which do not require the same protections as retail investors and may have lower liquidity needs. The Exchange provides post-trade information to the public via its website, following the close of each trading session; the brokers have access to trading information in real time. The BVES is demutualized with its stock listed on the Exchange. It has 315 shareholders, which represent a diverse group of companies and individual investors; brokers together hold only 1-2% share and there is a limit of maximum 0.5% share per shareholder. The BVES is managed by a board of directors comprised of seven members, all of whom must be shareholders of the Exchange by law; four members are associated with brokerage firms and three are independent with no ties to the securities market.

42. **Clearing and settlement system in El Salvador has seen some positive developments since the last FSAP and Delivery versus Payment (DVP) is now reasonably achieved.**

*Central de Deposito de Valores S.A. (CEDEVAL)*, owned by BVES, is the central securities depository charged with the custody, transfers, and clearing and settlement of securities. 98% of securities are now dematerialized allowing for electronic transfer of ownership. Current settlement cycles vary depending on the market segment, but will migrate to T+3 following the integration with Panama. At the moment, CEDEVAL only handles securities settlement, which is done on a gross basis, with funds settled by BVES in central bank money on a net basis. Securities settlement is linked with the Real-Time-Gross Settlement (RTGS) system but straight-through-processing (STP) has not been achieved. DVP is achieved by effectively blocking securities following a trade, which then await clearing of funds; once the latter occurs, the securities are transferred. CEDEVAL will soon be adopting a new IT system, which will allow it to conduct settlement of both securities and cash legs and using STP.

43. **Despite these advancements, the clearing and settlement system remains exposed to some risks.** Settlement finality for funds or securities is not covered at the level of the law, despite the RTGS system being designed to provide clear and final settlement; netting also does not have legal recognition, posing a legal risk to the netting system for cash settlement of securities, among others. In addition, settlement delays and cancellations are common. In case of a problem with a transaction, the preferred solution is to get both parties to cancel the trade. The BVES has an overdraft arrangement and CEDEVAL a guarantee fund, both of relatively low amounts; the former has been used on a number of occasions, but the latter has not.

**VII. REGIONAL INTEGRATION**

44. **Regional integration holds a lot of potential, given El Salvador’s small market size and typical structural challenges of smaller economies.** With an economy dominated by small, family-owned businesses with only a limited pool of companies capable to go through a

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36 T+0 for repos, T+1 for primary market transactions in non-government debt, and T+3 for all government debt and secondary market transactions of nongovernment debt and equity

37 Although, separate shorter cycles could still be maintained for certain securities

38 See Technical Note on Financial Sector Infrastructure.
securities issuance process limits the potential issuer base in El Salvador; with relatively low levels of employment formalization and financial education, there is a relatively low base of savers, which limits the pool of potential investors. All of this makes it particularly challenging for the country to expand its securities market beyond a certain size. Regional integration can help small countries like El Salvador attract new issuers and investors, build capacity and achieve higher market standards, leapfrog learning and innovation, and take advantage of economies of scale and scope. All of this also raises the visibility of the market in the eyes of global investors.

45. Integration efforts with Panama, and potentially others down the road, are thus a welcome development but will require careful analysis to mitigate potential risks. El Salvador needs to carefully assess all legal, institutional, operational, supervisory, and clearing and settlement arrangements to allow the integration to take place smoothly and safely. This is particularly critical, given Panama’s much more open financial system and increased risks of money laundering and financing of illicit activities (e.g., drug trafficking). Assessing the level of broker supervision and custody and settlement protections in Panama will be of particular importance to mitigate potential risks.

46. Expanding integration beyond El Salvador and Panama may be challenging. Considering a number of previous regional integration attempts in Central America (e.g., AMERCA39), the actual formalization of integration efforts between El Salvador and Panama is a significant step forward. However, expanding integration to other countries in the region may be more challenging due to some of the previously encountered obstacles, such as legal restrictions, wariness about losing ground or entering an unequal partnership where some are likely to gain/lose more than others, and relative underdevelopment of certain markets, which makes them less prepared for integration. Thus, while other countries, such as Dominican Republic and Nicaragua, have reportedly shown strong interest to join El Salvador and Panama, whether or not this is actually implementable remains to be seen.

47. The region seems ripe for formal integration given an increasing level of cross-border capital market activity already taking place, which attests to the business case of integration from the private sector perspective. Financial institutions, such as banks, brokers, and rating agencies, in El Salvador and in other Central American countries are increasingly regional in nature, setting up branches and buying out local companies in other countries of the region to expand regional operations. Issuers and investors are also eyeing regional opportunities for better interest rates, easier registration procedures, better regulatory structures, greater investment opportunities, or cheaper fees or taxes, among others. For example, El Salvador’s well-regarded securitization framework has been attracting interest from countries like Honduras and Guatemala, where potential infrastructure issuers are considering to issue securitizations in El Salvador because of the robust regulatory framework but also because of more attractive fixed interest rates and longer tenors. At the same time, some Salvadoran issuers may be increasingly

39 Alianza de Mercados Centroamericanos.
interested in a dual listing in Panama, not only to access investors in Panama but also globally through Panama’s existing link with Euroclear, which is slated to open for nongovernment debt securities later this year.

VIII. RECOMMENDATIONS

Market segments

48. **The Ministry of Finance should be granted more flexibility to perform adequate debt management and strengthen government debt market development.** The legal restrictions that restrict the government’s ability to issue debt with over 1 year maturity and to conduct liability management operations has the objective of limiting the overall public sector indebtedness. However, this leads to ineffective and inefficient debt management that could, in the end, be more costly for the government. Moreover, the Budget Law already controls the overall amount of government issuance per year. Granting more flexibility to the Ministry of Finance would allow the government to restructure existing debt to reduce refinancing risk and market fragmentation, develop a more orderly and predictable issuance program across the maturity spectrum, and build a comprehensive and liquid benchmark yield curve that could also support development of nongovernment instruments.

49. **The authorities should consider extending the placement period for securitizations to facilitate the placement process for these instruments and support their economic viability.** Six months is a relatively short period for placing at least 75% of the authorized issuance amount and can create difficulties for issuers that can be two-fold. First, issuers face the risk of having their entire issuance canceled if they only secure partial placement of the minimum 75% of the authorized amount. In the current context of increased uncertainties for local pension funds, it may take longer to identify suitable investors for an issuance, including potentially looking for investors abroad. Second, some securitization issuers, even if they manage to secure the minimum required investment for their issuance, have to bear the cost of carry because they do not need the full amount of financing right away. In other words, they end up having to park the extra funds raised in a low-yielding bank account or another safe investment while already responsible to pay interest on these securities. The difference between the interest rate to be paid and the return earned on the unneeded funds is the cost born by the issuer.

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40 Panama has an expedited process for registering securities that have already obtained registration with the Salvadoran authorities.

41 The mission understands that only an actual registration in the Panamanian market would allow a security to become Euroclear eligible; the envisioned integration through the remote operators model would not.

42 Panama launched the link with Euroclear in April 2014, which initially allowed Panamanian government securities to become Euroclearable and would open up to other instruments in subsequent phases.

43 There is a grace period of 3 years on the payment of principal.

44 At least one issuer, CEPA, the issuer for the airport securitization, experienced this situation.
50. To stimulate greater financing through capital markets for strategic sectors such as infrastructure and SMEs, the national development bank Bandesal could expand its offering of credit enhancement instruments. Currently, as part of its different product offerings, Bandesal provides investments and/or loans for select sectors, including infrastructure; however, these are of relatively small number and magnitude, ranging around US$ 5-25 million per project. For larger infrastructure development needs of the country (e.g., for projects over US$100 mn), Bandesal would not have financial capacity to provide such direct financing. Here, credit enhancement instruments could be more effective, especially if the projects are considering financing through capital markets, such as, partial credit guarantees for principal or coupon payments of bond investors, liquidity and/or interest payment guarantees during the construction period, etc., all of which would give more comfort to bond investors.

51. Similarly, Bandesal could expand its guarantee offerings for the SME sector by supporting SME lenders in obtaining financing through capital markets. SME lenders include firms, such as microfinance institutions, factoring and leasing firms, and other financial institutions solely dedicated to extending credit to SMEs. By partially guaranteeing their bond offerings, Bandesal can help these usually first-time issuers improve their credit rating and achieve greater success in attracting investors at favorable prices.

Issuance framework

52. To increase the efficiency of the securities authorization process, the SSF should gradually transition to the role of ensuring proper disclosure of information as opposed to solvency of issuers. However, this is a longer-term objective that requires a number of changes before it could be achieved.

53. Chief among these is the need to strengthen the supervision of key intermediaries involved in the issuance process to increase their level of capacity, accountability, and compliance with stated duties. This includes brokerage firms and credit rating agencies (CRAs), whose work in the issuance process is sometimes called into question. Specifically, the SSF should clarify the roles and responsibilities of brokerage firms to conduct due diligence of issuers they represent and duly prepare all required documentation. This could be done by, for example, publishing acceptable standards and frequently made errors, as well as carrying out proper enforcement for incompliance with stated requirements. The SSF should also strengthen its supervision of CRAs to: (i) ensure that they publish their rating methodologies in a transparent and comprehensive manner to allow investors to analyze them and determine how much weight to assign to the ratings in their investment decisions; (ii) ensure that they are complying with their stated rating methodologies; and (iii) confirm that they have proper governance arrangements in place to address conflicts of interest. During an actual issuance review, the role of the SSF should be to make sure that the reasons for a rating are well-
explained; checking whether a CRA is following its stated methodology should be done as part of its ex-post supervision.45

54. In the short-term, the SSF should speed up the implementation of the system for electronic documents and shorten and simplify the issuance process for banks. The SSF should accelerate the implementation of an institution-wide IT system, currently in the works, that will allow receipt of electronic documents, which, coupled with the adoption of the Electronic Signature law, expected soon, will bring important efficiencies to the securities issuance process. The SSF should also make an effort to shorten the time needed to obtain a “no objection” for banking issuers, given that the Banking Superintendency regularly receives financial information and assesses the solvency of the banks that it supervises.

55. Additionally, the regulator, the Central Bank, should develop a frequent issuers regime to provide faster and more efficient access to regular users of capital market financing. This would be a fast-track authorization regime with fewer and simpler requirements for certain types of issuers that could be based on different factors or a combination of them, such as the nature of the issuer (e.g., financial, corporate), the frequency with which the issuer comes to market, type of security (e.g., plain vanilla), the amount issued over a certain period of time, etc. Related to this, in a more medium term, as the SSF continues to strengthen its ongoing supervision process of periodic information (see below), the concept of disclosure by reference could be adopted, which allows the issuer to make a reference to documents already presented to the Superintendency in a previous issuance. This would usually entail registration of a base prospectus and, for each subsequent issuance, presenting a term sheet with specific information about the issuance and any updates to the base prospectus.

56. In the medium-to-long term, the Central Bank, in consultation with SSF, should simplify certain issuance requirements, such as financial projections and a market study report, which add little value, especially as the SSF moves toward a more disclosure-based approval process. The SSF should eliminate the requirement of providing cash flow projections for the life of a debt instrument except for newly formed entities, such as project companies or securitization funds, which do not have historical financial performance indicators. These projections do not add much value as they are only estimates and unnecessarily overburden potential issuers; international practice is to use historical financial statements to understand a company’s performance, including cash flows. For newly formed entities, the projections could be useful but should be reviewed, again, with an eye towards adequate disclosure as opposed to solvency. The latter is the job of investors and their advisers to determine and decide whether or not to go ahead with a particular investment. In addition, the regulation should eliminate the market study requirement, whose objective seems to be to ensure that there is demand for the security being issued. Similarly, this function does not rest with the Superintendency but with the brokers, who identify the potential demand of a security as part of their due diligence duties.

45 As long as a CRA is in good standing with the regulator, the regulator should assume that the CRA is following the methodology, unless there are any obvious red flags that necessitate for the situation to be addressed right away.
57. **To increase ways in which companies can come to the securities market, the SSF could consider allowing private offerings in the longer term.** Many nongovernment bond instruments, especially more complex ones in nature, such as securitizations, are often tailor-made for institutional investors, the primary buyers of these securities; this is the case in other markets globally, as well as in El Salvador. Institutional investors are considered well-informed and resourced players that are able to perform their own due diligence and thus do not require the same level of protections as do retail investors. Hence, mandating that such products always go through a regular public offer issuance process and be listed on the exchange, a process that is meant for offers seeking a wide public distribution, can unnecessarily add to the cost of issuance for these instruments.

58. **For the above reason, many jurisdictions have created a space for private offerings, where issuance requirements and approval are no longer part of the regulator’s purview.** Rather, they are contractually agreed between issuers and target investors; placement of securities is also done directly, outside of the exchange venue. Another alternative is hybrid offer regimes, which do remain within the regulator’s scope but entail significantly lower issuance requirements and faster approval process (usually automatic) for offers that are targeted solely for qualified investors (e.g., institutional and/or high net worth). These alternative issuance regimes are meant to provide additional options for issuers to enter the market, depending on their specific financing needs, and may require modifications to the Securities Law.

59. **It is recommended that the ongoing supervision of issuers be strengthened along several aspects.** These include: (i) requiring submission of periodic financial statements for entities originating securitizations, given that El Salvador has predominantly whole business securitizations, as explained above; (ii) development of a clearer guidance for reporting of material events, possibly through a regulation, and clarifying that the timeframe for their reporting should be immediate, which is the very notion of material events (not having differentiated deadlines, as is currently the case per the Exchange’s *Instructivo*); and (iii) development of a more systematic supervision process, which includes development of basic financial indicators in the short-term and of a more comprehensive automated system of indicators and alarms in the long-term, which would also include a more systematic review of qualitative information (e.g., material events).

60. **The requirements for the purchase and trading of foreign securities in the local market should be simplified to increase available investment instruments for domestic investors, namely pension funds and retail investors.** Foreign securities destined for the secondary market should not be subject to registration requirements with the SSF as required for primary issuances. Rather their purchase should be regulated through the investment advice function of brokers, subject to conducting client suitability and providing their clients with adequate ongoing information on investments. The other investors affected by this requirement

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46 Points (i) and (ii) being regulatory in nature, would need to be approved by the Central Bank.
are pension funds, which, as professional investors, can make investment selections according to their own policies, prudential norms, and risk-return strategies as they do for any other investment.

**Investment framework**

61. **Pension funds should be allowed greater flexibility to invest in foreign securities to increase their ability to achieve better portfolio diversification.** In the longer term, purchase of lower-rated instruments and private offers should also be allowed. Already investing close to 80% in government securities, the bulk of which is in low interest rate CIPs, pension funds are in great need of risk-return diversification. Increasing their portfolio limit for foreign investments and eliminating the requirement for locally registered securities with two local credit ratings would expand their pool of available investments and allow them to improve their portfolio returns. This, in turn, increases their available investment assets, which would not only benefit the pensioners, but also can be channeled to finance important financing needs domestically. Over time, with an increased focus on risk-based supervision of pension funds and global trends toward reducing regulatory reliance on ratings following the global financial crisis, the authorities should consider lowering or eliminating the minimum rating requirement for pension funds; investments in private/hybrid offers at a reasonable investment portfolio limit should also be considered.

62. **The authorities should consider revising the draft investment regulations for investment funds to provide more flexibility with regards to foreign investments and liquidity requirements.** Specifically, the market presence (*presencia bursatil*) should be made more flexible regarding the characteristics of securities that could be considered to comply with the liquidity, maturity or rating requirements, considering the local liquidity conditions.⁴⁷ Investment funds should also be allowed to invest in foreign securities in the secondary market without them being registered locally, though this may require a change in the Investment Funds Law. The latter is particularly important to allow these new investors to bring a differentiated investment strategy to the market and thus fulfil their expected role of diversifying the domestic investor base.

**Market Intermediaries**

63. **Conduct regulation and supervision for brokers related to the offering of securities products to clients should be strengthened along the following main lines:**

- There needs to be a clear definition of investment advice as a distinct service that could be provided by brokers. While a current draft regulation about administration of individual portfolios opens the possibility to offer an investment advice service, it is recommended to

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⁴⁷ Under a prior draft, a more restrictive requirement had been included, requiring the daily tradability in order to be considered of “market presence,” however, this requirement was eliminated from the final version.
develop a more comprehensive regulation on investment advice going beyond individual portfolio management.

- To create more homogeneity in brokers’ practices of profiling clients, it is recommended to encourage development of a standardized questionnaire to be used by the industry, which, for example, could be developed by the association of brokers.

- Deliberately offering products outside of a client’s investment profile should be prohibited.

- The SSF should prioritize supervision of broker conduct as the institution moves towards risk based supervision.

- Finally, in the long-term, the authorities could consider development of an intermediary framework based on distinct activities, each with its own prudential requirements, specific obligations, and separate licenses, rather than a single license framework that is currently in place. Such a regime encourages specialization and promotes higher industry standards and practices. Draft market conduct regulation is currently under development.

**Secondary market and pricing**

64. **To support secondary market trading, the authorities could consider creating a more level playing field in the application of the financial transactions tax to short-term securities by allowing the tax to be pro-rated.** The implementation of the 0.25% tax is widely cited as a key factor in the reduction of secondary market activity. One indicator of this decrease is a steady reduction in the monthly year-on-year growth in the secondary market volume from close to 200 percent in January 2015 to negative 12 percent in December 2015. While it will be difficult for fiscal reasons to remove such tax, a more level playing field could consider pro-rating the tax for short term instruments as is done with repos.

65. **To help stimulate better price formation and greater liquidity, the Exchange could consider implementing a type of call market for certain less liquid securities.** Such an arrangement involves concentrating trades in certain predetermined securities on specific days of the week and thus allowing more potential orders/quotes to accumulate ahead of the trading period. Availability of more quotes increases competition, facilitates better price formation, and promotes liquidity.

66. **To improve securities valuation and pricing, specific short- and long-term actions are recommended.** In the short-term, the draft regulations on price vendors and valuation of investment fund portfolios should be adopted in a timely manner. In the long-term, a comprehensive regulation on valuation of securities should be developed for the entire financial

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48 For example, investment advice, management of individual portfolios, management of collective portfolios, structuring and registration of issuances, receipt and transmission of orders, execution of buy and sell orders for third parties, custody of securities, etc.

49 Per data provided by the Exchange.
sector to encourage consistency in valuation practices across different financial institutions domestically, as well as better alignment with international practices. Regulatory drafts in this area will allow utilization of specialized price vendor agents or qualified international methodologies and agents.