

Corporate Bond Market in Serbia ¹

Katarina Đulić

Boško Živković

Introduction: Potential risks and benefits of developing the corporate bond market

The corporate bond market can be a good alternative to borrowing from commercial banks. The main advantages of developing this market are the following:

- A corporate bond enables collection of relatively large funds from more sources than would be possible by taking loans. The total debt amount is dispersed into several smaller amounts that are sold to a larger number of investors. This phenomenon is particularly evident in the period during and after a banking crisis;
- The corporate bond market could, as competition to the banking sector, lead to lower costs of external borrowing.

Advantages of corporate bonds, as instruments for collecting borrowed sources, can be favourable tax treatment and lower source cost in relation to equity capital. Compared to other borrowed sources, corporate bonds enable collection of larger funds without changing the ownership and management structure. Furthermore, in conditions where there is an efficient enough corporate bond market, companies no longer depend only on bank financing, which results in extending financing terms and lowering the interest rate. If banks legitimately approve funds on a shorter term than the one on which the funds would be collected on the financial market, this could result, on the same level of financial leverage, in companies assuming greater risks due to a shorter maturity period. It has also been observed that in the banking sector, in conditions with no competition, there is a higher level of concentration of deposits and loans in the group of leading banks. All these phenomena increase the cost of borrowing and widen the interest spread.

Absence of a functional corporate bond market generates unfavourable choices for investors, especially for the group of so-called institutional investors. They are forced to replace these types of assets with substitutes of all kinds and most often with bank deposits. This group of investors is forced to accept lower rates of return from these substitutes.

Corporate bonds have a particularly important role in times of crisis. A crisis on bond markets leads to withdrawal of investments in these instruments. In times of crisis, aversion to risk is intensified. Investors change the structure of their portfolios in favour of financial instruments that yield smaller but lower risk returns. And a corporate bond is that kind of an instrument.

Characteristics of the national corporate bond market affect the stability of the financial system. A dysfunctional corporate bond market leads to leverage growth in the corporate sector and to over-reliance on the banking sector. Furthermore, lack of accounting transparency, regulatory imperfections and problems with moral hazards could cause a disruption in the banking sector. In post-crisis periods, a strong expansion of the corporate bond market has been observed. A typical example is the expansion of this market in East Asia during the 1990s.

One of the causes of expansion of these types of markets during the normalisation period after the crisis is the possibility of a developed corporate bond market to stimulate and strengthen corporate sector restructuring. Furthermore, due to longer maturity than conventional loans, the corporate bond market reduces the risk of maturity gaps.

Corporate bond financing has serious drawbacks because it causes accumulation of fixed liabilities at the end of the maturity period and causes a great shock in liquidity at the time of principle debt repayment. Issuing of corporate bonds, as with any other type of borrowing, increases financial leverage. Issuing of long-term bonds that are used for financing investment projects requires more stringent terms than the issuing of short-term financial instruments, longer procedures and could have higher issuing costs, which affects the price of this source. This mechanism of acquiring additional capital basically follows the conjuncture of loan supply: in conditions of low or falling conjuncture, it is hard to place corporate bonds because individual investors have less information than the banks. In times of deep crisis, the corporate bond market dies out.

¹ The authors thank the Securities Commission and Erste bank Novi Sad who contributed greatly to this paper with their readiness to give relevant data and talk openly about challenges of the Serbian corporate bond market.

Development of the corporate bond market is predominantly conditioned by the level of credit risk of the business sector. This risk is usually bigger in undeveloped markets than in developed ones, primarily due to high leverage and lack of accounting transparency of companies. High credit risk lowers the demand for these bonds because when making a decision on investing in these securities, investors pay special attention to creditworthiness of the company that issued the bonds. That is why corporate bonds on undeveloped markets are characterised by different forms of credit risk hedges. Special provisions are a common occurrence, as well as various types of security. Issuing of corporate bonds on these markets is often secured by collateral, most often some permanent asset or third party guarantees, which reduce the credit risk of the issuing party through secondary source of payment. Insured bonds are less risky for the investor, but they are a more expensive source of capital for the issuer than regular, uninsured bonds.

A particular problem associated with credit risk is the efficiency of institutional infrastructure for credit risk measurement. In many countries, including the Republic of Serbia, there are no specialised institutions for measuring credit risk – the so-called rating agencies. Investors do not have enough reliable information about the characteristics of issuers.

Analyses of experiences of countries that have rapidly developed corporate bond markets do not allow formulation of a universal model of their development. Macroeconomic stability is a precondition, especially when bonds are issued in the national currency, when the deciding factor is the level and stability of inflation. Development of the government bond market, that generates a return curve, precedes the development of the corporate bond market.

1. Institutional environment and macro structure of the market in the Republic of Serbia

Serbia has a financial system in which banks play a dominant role. A loan is the basic source of borrowed capital. In the period before the crisis, the banking sector underwent rapid growth, absorbing domestic and large amounts of foreign savings. The non-banking sector grew at low rates.

The corporate bond market is in the initial phase of development. Individual investors are almost completely absent from this market. With few exceptions, banks are inactive as investors, issuers and underwriters of bond issues. Insurance companies and investment funds, as the only active players on this market, have relatively small surplus available for trading. Currency and credit risks are high. Infrastructure is undeveloped and regulation extensive and expensive.

Reforms in direction of deepening the financial markets, diversifying the instruments and increasing source of funding would reduce the domination of banks in the national system and increase its potential stability.

1.1. Sources of demand

On the side of potential demand for corporate bonds, under normal circumstances and in theory, institutional investors dominate. Institutional investors on the Serbian capital market are a group of investors that place their assets, although limited, in this instrument.

Under normal conditions, pension funds are a very important source of demand for corporate bonds. Until the start of implementation of the Law on Voluntary Pension Funds and Pension Plans, in Serbia there was only the first pillar of the pension system – mandatory government pension insurance, which operates on the “pay as you go” principle, which means that the contributions of currently employed workers are deposited into pension insurance funds and from there directly distributed to current pensioners. With the legislative reform, the third pillar of pension system was introduced – voluntary pension insurance, which gave an opportunity to all citizens, whether employed or not, to allocate additional pension contributions to individual accounts and thus secure additional pensions in the future. Unfortunately, it quickly became obvious that long-term dinar financial instruments are missing that would provide adequate diversification and more diverse investment of these funds. Bearing in mind that average age in Serbia is high and that the first pillar is overburdened and is practically paying out pensions at the level of social welfare, a growth in assets of these funds should be expected in the future.

Investment policy of voluntary pension funds is defined in the local legislature in line with the following principles:² **asset security principle** which implies that the structure of the portfolio of voluntary pension fund contains securities of issuers with high credit rating; **portfolio diversification principle** which requires the portfolio structure of the-

² Law on Voluntary Pension Funds and Pension Plans of the Republic of Serbia, Article 30.

se funds to contain securities that differ by type and issuers, as well as other features; and **principle of maintaining adequate liquidity** according to which the portfolio structure of a voluntary pension fund must contain securities that can be quickly and efficiently bought and sold at a relatively stable price.

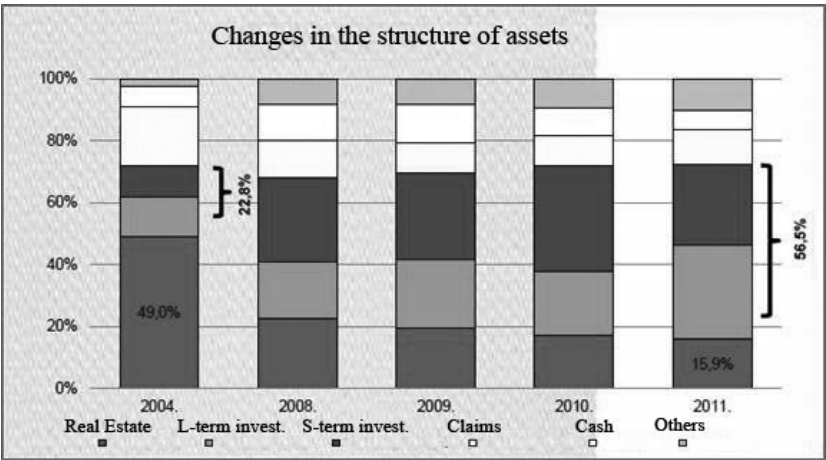
In order for these principles to be applicable, the same law defines special rules that give an overview of possible investment alternatives.³ In addition to investments in debt securities issued by the Republic of Serbia, autonomous provinces and local self-governments, as well as other legal entities with state guarantees, in line with the law that regulates public debt, investments in debt securities are also allowed, as issued by foreign governments or foreign legal entities with minimum “A” credit rating, which is determined by rating agencies Standard and Poor’s, Fitch-IBCA, Thompson Bank Watch or Moody’s; as well as in securities issued by legal entities headquartered in the Republic of Serbia, that are traded on an organised market within the state. So, the law allows investments in corporate bonds as well, which would be traded on the Belgrade Stock Exchange (BSE), and thus the law created conditions for defining a demand for corporate bonds.

According to the National Bank of Serbia Report on the sector of voluntary pension funds in Serbia for the second quarter of 2012, which came out in August 2012, the largest share in total assets of funds is held government securities with as much as 85.4%. They are followed by term deposits with 5.6%, shares with 4.1% and demand deposits with a 3.4% share. About 0.6% of asset funds were invested in property. At the end of the second quarter, there was 3.18 bn RSD in foreign currency, in euros, i.e. 22.3% of total assets, while there was 11.10 bn RSD in local currency, i.e. 77.7% of total assets. After a significant decrease in share of funds in foreign currency of around 16 percentage points in 2011, the National Bank claims that during 2012 this share was stable – between one quarter and one fifth of total funds.

Analysis of pension funds’ portfolios in Serbia shows that these institutional investors barely invested in corporate bonds. In addition, the portfolio structure of these funds indicates that the state is financing its own needs through long-term savings of citizens, thus considerably diminishing the demand for corporate bonds. Despite the above-mentioned principle of diversification, most of the assets of Serbian pension funds bear a credit risk that is highly concentrated in investments in government debt instruments. In addition, over 90% of portfolios are exposed to risk of volatile interest rates, which is the result of high share of debt instruments in funds’ portfolios.

Another group of significant institutional investors that are investing in corporate bonds are insurance companies, especially the life insurance business. Insurance companies in Serbia started dealing with life insurance and thus acquired good quality sources of funds that need to be invested. The Law on Insurance prescribes an investment policy for technical reserve funds, which can also be invested in bonds, i.e. other debt securities traded on an organised securities market in the country, as well as bonds and other debt securities that are not traded on an organised market, whose issuer is a legal entity established in the country.⁴ Quantitative restrictions are prescribed by the decree of the National Bank of Serbia and are relatively flexible towards limits for pension funds.⁵

Chart 1: Asset structure of insurance companies



Source: http://www.nbs.rs/internet/latinica/15/mediji/prezentacije/20120612_MEJ_prezentacija_osig.pdf

3 Law on Voluntary Pension Funds and Pension Plans of the Republic of Serbia, Article 31.

4 Law on Insurance of the Republic of Serbia, Article 114.

5 Decision on Restrictions of Certain Forms of Depositing and Investing of Technical Reserve Funds and on Maximum Amounts of Individual Deposits and Investments of Required Reserve of Investment Companies ("RS Official Gazette, no. 87/2012).

Regarding the demand for bonds, according to the data available on the website of the National Bank of Serbia, the changed structure of assets of insurance companies over the last few years at first glance gives cause for optimism. That is, the share of long-term financial placements in assets is increasing.

However, a more detailed analysis shows that these institutional investors primarily place their available funds in government debt securities. According to the National Bank of Serbia Report on insurance sector in Serbia for the second quarter of 2012,

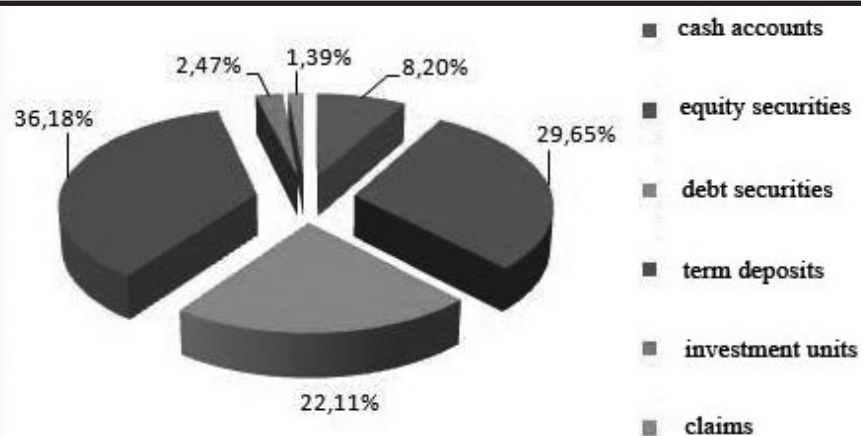
which came out in August 2012, observed in total for all companies dealing with insurance business in Serbia, the non-life insurance technical reserves were mostly covered by government securities with 30%, bank deposits with 23%, cash with 13%, investment in real-estate with 9%, and claims of undue premium with 8%. The structure of coverage of life insurance technical reserves is dominated by investments in government securities with 85%, followed by bank deposits with 8%.

In 2011 and the second quarter of 2012, the share of intangible assets, real-estate, investments in securities that are not traded on the market (and those are all issued corporate bonds except those issued by Societe General Bank Serbia and recently Erste bank Novi Sad) and receivables (as type of assets that may be difficult to collect) in total assets of the company that is primarily dealing with non-life insurance was 38.09% and 38.61% respectively.

So, on the side of corporate bond demand, insurance companies are emerging as a significant source of demand relative to pension funds due to relatively small legal restrictions on the placement of funds of these institutional investors. However, these investors too, when choosing debt securities, tend to primarily choose the government issued ones.

Third important source of corporate bond demand are investment funds. They started doing business in Serbia as of 2006. The Law on Investment Funds defines the investment policy, which enables investing in securities issued by legal entities founded in Serbia, which are traded on an organised market in the country,⁶ which implicitly includes corporate bond instruments. A maximum amount of up to 10% of investment fund assets can be invested in securities, i.e. financial derivatives of a single issuer or fully in securities, i.e. financial derivatives of two or more issuers that are linked entities. The Securities Commission does not have publicly available information about the placement structure of investment funds, but it responded to the authors' request to submit an overview of placement structure of investment funds.

Chart 2: Asset structure of investment funds



Source: Securities Commission of the Republic of Serbia

In 2012, a relatively high 22.11% of investment funds in Serbia were placed in debt securities. A more detailed analysis of placements shows that these are government bonds, treasury bills, as well as corporate bonds of foreign issuers. The only paradox worth mentioning is that relatively more flexible legal requirements related to investment restrictions have led to a better diversified portfolio of investment funds related to pension funds, but not to a considerably higher demand for corporate bonds.

On the whole, it is difficult to say what is the cause of undeveloped corporate bond market in Serbia – weak supply or low demand. On the one hand, as this article will show further, the corporate bond offering is very modest due to multiple reasons, most important being – relatively unstable macroeconomic environment, unstable inflation and domestic currency, non-transparent business operation of local companies, etc. On the other hand, analysis has shown that on the demand side, institutional investors in Serbia (as potentially the most significant source of corporate bond demand) are facing a large number of investment restrictions for securities, not so much because of the legal restrictions, but because of the very modest supply in the sense of type and quality of securities. Therefore, the question arises as to how big is the actual potential demand for corporate bonds, which are obviously estimated by the market as too risky of an instrument for investment policy of Serbian institutional investors.

⁶ Law on Investment Funds of the Republic of Serbia, Articles 29 & 30.

1.2. Supply sources and conditions

The necessary condition for development of a functional and efficient corporate bond market in Serbia is a high quality legal and institutional framework. The main elements of a legal framework are the adoption and strengthening of efficient legislation that would regulate the capital market, but also important are company bankruptcy procedures with clearly defined rights and creditor payment hierarchies, as well as adoption and strict implementation of accounting standards that will enable availability and reliability of relevant financial information.

In May 2011, the Law on the Capital Market was passed, the fourth one in a row, accompanied by changes to already mentioned Law on Investment Funds, Law on Voluntary Pension Funds and Pension Plans, and Law on Takeover of Stock Companies. The Commission adopted more than 20 by-laws that were necessary in order to implement the Law on the Capital Market. All these changes were a step in the right direction, because their aim was harmonisation with EU legislation and IOSCO principles.

The new law distinguishes between regulated, existing and functioning so-called OTC market. This is an important innovation since the previous law favoured bond trading on the stock exchange. The OTC market is a secondary market for trading financial instruments, which does not have to have a market organiser and whose system of trading involves negotiations between buyers and sellers of financial instruments with the aim of closing the transaction. The term “regulated market” is defined as a multilateral system organised and managed by the Belgrade Stock Exchange and it has two market segments – listing and Open Market. Listing is further divided into the Prime and Standard market. The following table sums up the conditions for listing securities (including debt securities).

Table 1: Conditions for bond listing on Belgrade Stock Exchange

Length of operations	Prime Listing 3 years	Standard Listing 3 years
Business results	positive	/
Auditor's opinion	positive opinion	positive opinion and opinion with reserve
General conditions, which are held during the listing period	minimum amount of capital	
	20 mil. EUR	4 mil. EUR
Special conditions for actions and depositary receipts for shares of the publisher	report on the audit of the annual financial statements with excessive positive opinion and opinion with reserve	
	Web site of the issuer - available in Serbian and English	
	that there is in the public in free circulation (free float), an alternative at least 25% of shares of the total issued shares of the issuer	at least 25% of shares of the total issued shares of the issuer
	shares of minimum capital value of EUR 10 million are owned by at least 500 shareholders	shares of minimum capital value of EUR 2 million are owned by at least 250 shareholders; shares that are owned by at least 500 shareholders
	that dividends are paid for priority actions, if issued - as determined by the decision of their issuing	minimum level of share market liquidity
Special conditions for debt securities	The average daily value of transactions - at least 500 000 RSD and the average daily number of transactions - at least 5 transactions in the past six months:	
	That the issuer did not operated with a loss in his latest financial report	
	at least 10 mill. EUR	emission value at least 1 mill. EUR
	that the account of the issuer was not blocked in the last 180 days	that the account of the issuer was not blocked in the last 60 days

Source: Belgrade Stock Exchange website

Currently there are four Government of Serbia bonds listed on Prime listing (bonds issued for settlement of foreign currency savings debt) with different maturity dates (from 31 May 2013 to 31 May 2016). There are no bonds listed on the Standard listing. There are no corporate bonds listed on any of the Belgrade Stock Exchange listings.

On the other hand, conditions for including securities on Open Market, as well as continually throughout the securities listed on the Open Market, are shown in the following table.⁷

Table 2: Conditions for including securities in Open Market, as well as continually throughout the listing of securities on Open Market

(1) that the issuer has no running bankruptcy or liquidation procedures;	
(2) alternatively, minimum/at least:	1) 300,000 EUR – amount of permanent capital, i.e. Book value of capital according to financial statements from the last accounting period, which preceds submission of request from Article 61 of these Rules, or the amount of market capitalisation of shares that are traded on another segment of the regulated market, i.e. MTP, or
	2) 15% shares distributed in public (free float).
Exceptionally, the Stock Exchange can approve inclusion of securities on the Open Market if it deems it in the interest of issuer and investors, taking into account the minimum amount of capital and market capitalisation, as well as the free float percentage.	

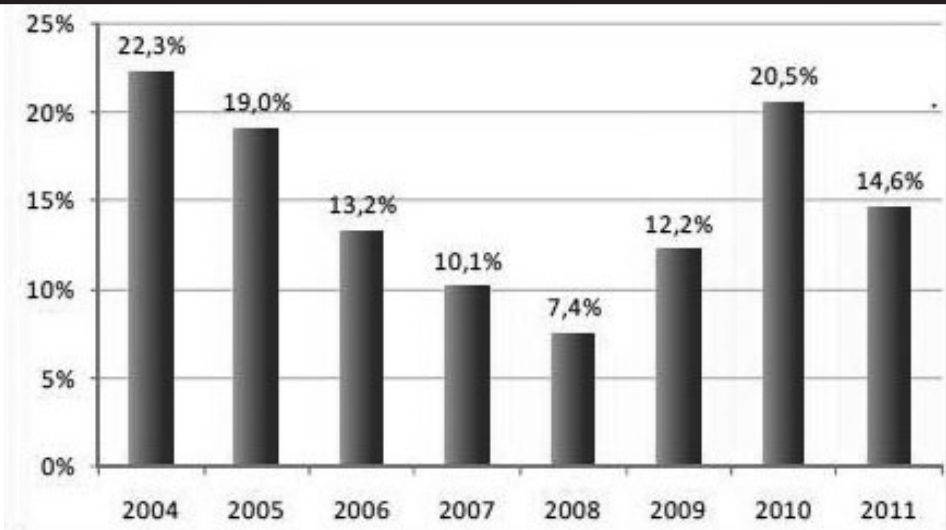
Source: Business rules of Belgrade Stock Exchange

Open Market has shares of 134 issuers and bonds of two issuers: Societe Generale Bank Serbia JSC Belgrade and Erste bank JSC Novi Sad. Those are currently the only debt securities on Belgrade Stock Exchange that were not issued by the Government.

Other issued securities are included in Multilateral trade platform on Belgrade Stock Exchange (MTP) – 979 shares 966 issuers. No bonds on MTP.⁸

In 2011, turnover of nearly 41 mn EUR was realised on BSE in trading the stated debt securities, which makes it 10% lower than last year.

Chart 3: Bond trading on BSE (in % of total turnover)



Source: Report on business operations of Belgrade Stock Exchange for 2011.

Recently Erste Bank JSE Novi Sad had a successful issue of debt securities through public offering. It was an issue of long-term bonds with nominal value of almost 1.5 bn RSD. Having in mind that all other issues of corporate debt securities in Serbia were closed (including the issue of Societe Generale Bank which was initially closed), this public offering is certainly important.

⁷ Business Rules of Belgrade Stock Exchange JSC Belgrade, Article 64.

⁸ Data taken from BSE website on November 14, 2012.

Why is public offering of corporate bonds so rare? Does the law create obstacles? Under the new Law on the Capital Market, the basic principle that public offering is based on is mandatory publishing of a prospectus with prior approval of the Securities Commission. Without such approval, the public offering would be considered void, except in cases clearly specified by the law.⁹ The law emphasises that inclusion of securities on a regulated market, or rather MTP in Serbia, is not allowed if prior to their inclusion a valid prospectus is not published, except in cases clearly stated in the Law.¹⁰ Article 12 of the Law states under which conditions is a closed issue allowed (private placement). Public offering should be a general principle and refers both to the sale of securities made during the issue of securities, and to the trading of securities on the secondary market. Striving to make the offering public through the Law on the Capital Market is actually striving to provide adequate protection for the investors (especially regular, non-professional investors) through rules on publishing all relevant information on securities that are the subject of such an offer, and in line with accepted international standards and principles, which is certainly a good intention.

Investors are protected by information not only at the moment a security enters the market, but continually as long as that security is listed or quoted on an organised market. In that sense, aside from the already mentioned conditions, the main differences between described markets and market segments refers to obligations of making business operations public and transparent. Needless to say, the differences are considerable and they decline going from Prime Market to MTP.

According to the Rules of the BSE listing, in addition to reports, information, decisions and other prescribed data that the issuer reports on as a public company whose securities are included on regulated market in line with the law, by-laws and stock exchange regulations, the listed issuer also has to submit: (1) quarterly report – at the end of each of the first three quarters of the current fiscal year, within deadlines prescribed by the law, as well as make this report available to the public for at least five years from the date of publishing; (2) filled out BSE questionnaire about issuer's corporate management practice, which is submitted to BSE on the day of submitting annual report at the latest; (3) in case circumstances arise which could significantly affect the business operations of the issuer and the price of its securities, and they are not commonly known, the issuer is obligated to inform BSE of these circumstances immediately and without delay; (4) report on holding a session of issuer's officials where it is being decided on: financial reports (unrevised and/or revised, unconsolidated and/or consolidated); annual reports; semi-annual reports; quarterly reports for first and third quarter of the current fiscal year; payment of dividends and interim dividends (including a motion that the relevant body decides on); changes to initial capital of the issuer; acquisition/disposal of its own stocks. The issuer is obligated to submit the reached decisions to BSE on the first working day following their adoption; (5) additional reports and information at BSE's request in case this is necessary for complete and timely informing of investment community; (6) other reports and information defined by contract that the issuer signs with BSE. The issuer has to submit the stated reports and information to BSE both in Serbian and English language, as well as publish them in these languages on its website. The stock exchange publishes these reports and information on its website. These requirements are commendable from investor's point of view, but they pose a great expense for the issuer.

On the other hand, the issuer whose securities are included on the Open Market has to submit to the BSE: (1) annual report for previous fiscal year; (2) semi-annual report for current fiscal year; (3) reports on any changes in rights of shares, for each class of shares separately, including changes in rights of derived financial instruments issued by the issuer, which give rights of acquiring its shares; (4) annual document on published information; (5) report on changes in significant share in issuer's capital; (6) information on acquiring or disposing of owned shares; (7) notification of holding a Board meeting, with an invitation to the meeting in line with the law that regulates enterprises, including the proposal for changes to company statute or memorandum of association in case they are being decided on at the meeting; (8) notification of award and payment of dividends; (9) report on issue of new shares, including information on possible new assignment, registration, cancellation or exchange of shares, as well as on new issue of debt securities, and especially on the insurance or guarantee related to that issue; (10) additional reports and information requested by BSE that are important for protecting investors and securing proper, efficient and transparent trade of these securities on the stock exchange; and (11) other prescribed data (reports, information, decisions) in line with the law and by-laws. Issuer of securities that are not shares is obligated to submit to BSE annual and semi-annual report, as well as reports on changes in the rights of those securities, including the changes in conditions that could indirectly affect the changes in rights of those securities, and especially changes related to conditions of borrowing and interest rate. Unless otherwise stated by the law, same rules apply to issuers whose securities are included on MTP Belex.

⁹ Law on Capital Market, Article 11.

¹⁰ Law on Capital Market, Article 11.

1.3. Causes of weak supply

If a smaller company in Serbia wanted to issue corporate bonds, it could probably do only on MTP. When the company realises which segment can compete for and starts the procedure of preparation and approval of the prospectus, there are no more differences between various markets (or rather market segments). In case of public offering, the exact same documentation is submitted to the Commission regardless of the market segment the security or issuer is competing for. The question is whether the corporate bond market development would have been more stimulated if conditions for public offering of corporate bonds on MTP were slightly more “relaxed”. In other words, this is a choice between stronger protection of investors and simpler conditions for issuers. Perhaps it should be pointed out that in recent times, even in EU the regulator is starting to question whether it is necessary to protect investors to such an extent or if it would be wiser to stimulate capital market development by more relaxed conditions for public offering of securities.

Issue requirements are far simpler for closed issues, which partly explains why (almost) all issuers who issued corporate bonds chose this way of offering their securities.¹¹

Informal interviews conducted by the authors of this paper with Commission employees and some issuers have led the authors to conclude that Serbia’s regulations might be too strict for an undeveloped market. Even the Foreign Investors Council (FIC) in their 2012 White Paper conclude that unfortunately new capital market legislation did not find its practical application, which would be the only true measure of success of regulatory reforms. They find that capital market in Serbia is too small in order to “test numerous novelties introduced by new legislation, and especially the Law on Capital Market”. On the other hand, lax legislation could lead to mass infringement of rights of investors that were registered on stock market over the last ten years.

So, when it comes to the corporate bond market in Serbia, it would seem the legislation is too demanding and restrictive for our conditions. On the other hand, the regulator is objectively confined by EU directives. It is therefore legitimate to question whether perhaps there was room to postpone strict harmonisation and to keep regulations that are more appropriate for this market. The new legislation is better in the sense that it is closer to EU regulations, but is far removed from our market reality.¹²

Another important regulatory issue in this area is the Bankruptcy Law, which was adopted by the National Assembly of Serbia on December 11, 2009 and has been implemented since January 23, 2010. Although the Law itself was a step in the right direction, FIC pointed to a number of problems regarding its application. For example, provisions on automatic bankruptcy in case of long-term insolvency of the debtor, were declared unconstitutional and ceased to exist, even though it is clear that such provisions are more than necessary in Serbia’s reality. Practice has shown that legislature’s intention to make the choice of bankruptcy trustee as transparent, impartial and just as possible did not yield desired results and that same trustees keep getting appointed by the same judges, while a large number of active licensed bankruptcy trustees did not get an opportunity to lead at least one bankruptcy procedure. Despite the changes to the law, bankruptcy procedure in Serbia still lasts considerably longer than in EU countries, and one of the main problems is relatively uneven jurisprudence. Without a more detailed analysis of this mechanism, it is already clear that when it comes to bankruptcy, a creditor in Serbia cannot count on satisfactory protection.¹³

1.4. Current balance of supply and demand

Previous findings have resulted in the assumption that the corporate bond market is shallow, illiquid and highly risky. Its size, measured by volume of issues, is negligibly small compared to the stock of bank loans.

There is a total of 42 issuers¹⁴ of debt securities on the CRHOV website. When we take out government and municipal bonds and short-term corporate debt securities, certain facts become evident: corporate bonds have been issued by three banks (Societe Generale Bank Serbia JSC Belgrade, Erste Bank JSC Novi Sad, and NLB Bank JSC Belgrade) and 3 companies from the real sector (Galeb GTE JSC, Telefonija JSC Belgrade and Tigar JSC Pirot). Analysis of

¹¹ We note here that perhaps municipal bonds should be offered through stock exchange, but they haven’t been available since the new law was passed. According to the previous law, Novi Sad issued debt securities in closed issues.

¹² A good illustration of this assessment is the Commission’s attempt to bridge this gap by delaying adoption of rules on adequacy of capital of investment companies. Even though the Commission has already prepared the draft of this legal document, it is trying to postpone its adoption because it is sensitive to the situation on the market. That is, when similar regulation was adopted on the developed Croatian capital market, within a year the number of investment companies dropped from 30 to 6.

¹³ FIC, White Paper, 2012

¹⁴ This data was taken on 15.11.2012.

these corporate bond issues shows that, except in the cases of the two banks mentioned, all others were closed issues. The liabilities structure of balance sheets of companies issuing bonds is dominated by long-term loans. All companies that issued corporate bonds rely primarily on bank loans. These are followed by corporate bonds, while use of leasing in most companies is at the same level as using bonds. Presence of bonds in Tigar JSC is significantly higher than in other companies due to three issues that Tigar had.

Analysis of buyers of corporate bonds has shown that there are often insurance companies among investors. For example, the entire issue of Galeb GTE bonds was bought by Wiener Stadtische, first issue of Tigar was bought again by Wiener Stadtische, and then Takovo Insurance company, and they were joined by Komercijalna bank. The second issue of Tigar was purchased by the buyers from the first issue, joined by DDOR Insurance, Wiener Re Insurance and KBC Bank. In the third issue, investors from second issue were joined by Jubmes bank. When it comes to banks, buyers were insurance companies, investment and pension funds and foreign legal entities.

In all cases of the real sector, it is clear that companies opted for closed issues to known investors who had close contacts with the company and who basically only lent money to the company using corporate bonds as a mechanism and form. Essentially, if we exclude the cases of three banks (or rather only two, since the issue of NLB bank was closed), Serbia had no issue of corporate bonds in the standard meaning of the term.

2. Regulatory and transaction costs

Aside from risks and regulatory restrictions, high costs associated with the issue of corporate bonds are a significant factor in hindering corporate bond market development in many transition countries, including Serbia. This section of the paper will explore whether costs of issue in Serbia are prohibitive.

Issue costs depend on characteristics of corporate bonds that are being issued and on registration procedures. Two basic ways of issuing corporate bonds (through public issue and private placement) have different costs. Public issue is costlier because it requires creating a prospectus that will be registered with relevant institutions, and based on which an offer for sale of bonds will be made. In the process of issue, the company is assisted by an investment bank. In addition to consulting, participating in the preparation and registration of the prospectus, the role of the bank is to facilitate the process of bond distribution. An investment bank can also act as the issuer's agent when it doesn't take on the responsibility of acquisition, but only the responsibility of the sale of issued bonds to investors. In that case, the risk for the bank is smaller, and the return is realised through agency commission, which presents a lower cost for the company.

Private placement is simpler since it does not require the entire procedure of registering the issue with the relevant institution. Through private placement, corporate bonds are sold to a small number of already known professional investors. This placement method has the lowest total cost of issue, but this advantage can be offset by higher cost of financing. Since the large part of issue costs is fixed, economies of scale apply. Privately placed bonds have lower liquidity since they cannot be traded publicly. The biggest number of corporate bonds in European transition countries has been issued as regular short-term bonds with fixed a coupon.

Costs of public issues entail different costs, which can be classified in five groups.

The first group is made up of investment bank's commissions for consulting in the process of issue, preparing documentation needed for the registration of issue and getting a credit rating, as well as of costs of signing issues. These costs are most often the biggest item in total costs of corporate bond issue on undeveloped financial markets. But with the increased competition in investment banking, these costs are getting lower.

The second group comprises costs of issue registration, its listing and standardisation. A large number of issues on developed markets is registered with relevant regulatory bodies and listed on stock exchange for higher liquidity. Corporate bonds can be registered as separate issues or they can be registered under the regime of shelf registration with one prospectus. In this procedure, the costs of registration decrease because only one registration of the issuer is needed, which can cover a longer period or a larger number of issues. In that case, the issuer can collect necessary funds quickly and efficiently. In most of the transition countries, the regulatory bodies should foresee this type of issue registration, because it will increase the flexibility of the issuer through a possibility of timely reaction to market conditions, increase the efficiency through lowering the cost of issues and increase the allure of corporate bonds as a source of financing. In South American countries, the process of issue involves delineation of roles of regulatory bodies and stock exchange in order to avoid doubling the efforts of supervisors and costs of issue.

The third group of costs are those of acquiring a credit rating, which also depends on the size of issue. These costs are not a required pre-condition for issue on all markets, but issuers often opt for rating the issue of corporate bonds because higher rating would mean a lower interest rate, i.e. lower cost of financing. Costs of establishing credit rating are lower for companies who often issue corporate bonds, because agencies have a database of issuers' basic information.

The fourth group are marketing costs, which depend on the level of investor dispersion, frequency of issues and regulatory requirements. Every investor has to be familiar with the offering for sale and the information in the prospectus.

Finally, the fifth group of costs are tax costs.

Transaction costs¹⁵ are a heterogeneous group of costs which are, directly or indirectly, incurred during market trading. They include costs of broker commissions, time spent on acquiring information before the trade, cost of tax on trade of financial instruments, and so on. Costs of clearing and payment systems are fixed. When a market is illiquid, costs per transaction stay relatively high and reduce the potential of cost savings from collecting funds through issue of corporate bonds. All this affects the lower number of market participants both on the side of issuers and investors.

Liquid secondary markets are cost effective, which can be directly seen through a narrower bid/ask spread. A direct and very rough estimate of transaction costs can be obtained by adding a bid/ask spread and cost of broker commission. When investors look at costs, they are often unaware of costs paid due to adjusting the spread of dealers. Dealer markets have the lowest cost of trading, because information on quotes is always available, and the time for finding the other side to do the transaction is the shortest. Spreads reflect the risk of holding securities that are necessary for doing a transaction and which are supposed to offset operational costs. Smaller spreads and higher quantity of transactions that dealers are willing to perform at quoted prices are indicators of the market liquidity. For example, in Slovenia, the issue of corporate bonds is less used than banking debt, because transaction costs are higher due to the small size of the market.

In most of the countries, the biggest part of issued corporate bonds is purchased and sold on the OTC market, and precise data on trade, prices, volume and costs is not available. Some countries are trying to encourage trade on organised markets through tax reliefs for this type of trade. For example, the Government of Peru lowered the tax on profit from interest for corporate bonds traded on the stock exchange. Stock trading is considered a more transparent and efficient way of trading that enables a wider base of participants and easier market access.

Transaction costs depend on the size of transaction¹⁶ and they significantly decline as the size of transaction increases. Highly rated bonds, bonds that were recently issued, and those whose maturity deadline is near, have lower transaction costs than others. Transaction costs are lower for corporate bonds with transparent prices, which implies that publicly traded bonds have also lower trading costs.

Issue costs in Serbia have all the stated cost groups. One of the reasons there were no significant issues through public offering of corporate bonds is the high fixed costs of issues that need to be paid in advance to the Securities Commission. Commission's fee for approving a prospectus is 0.20% of nominal value of securities issue.¹⁷

Costs of including debt securities on MTP at Belgrade Stock Exchange, which are the lowest, are paid as one-off fee in the amount of 10,000.00 RSD. Costs of organising a trade are paid as an annual fee of also 10,000.00 RSD for debt securities. In the year when securities are included in OTC market, the issuer does not pay the annual fee.¹⁸

In case the issuer wants his bonds traded on regulated market, in addition to fulfilling the requirements for securities listing, he has to pay the following expenses as well:

- For trading on Prime listing: one-off cost is 0.02% of issue amount, but no less than 160,000.00 RSD and no more than 480,000.00 RSD, and annual costs are paid as a commission on market value of the issue in the amount of 0.01%, but no less than 160,000.00 RSD and no more than 320,000.00 RSD.
- For trading on Standard listing: one-off costs are 0.02% of issue amount, but no less than 80,000.00 RSD and no more than 240,000.00 RSD, and annual costs are paid as a commission on market value of the issue in the amount of 0.01%, but no less than 80,000.00 RSD and no more than 160,000.00 RSD.

¹⁵ There is no single definition of this term. One group of authors argues that developing markets should introduce tax on securities transactions because this tax would reduce the excess trade and volatility of prices it produces. Opponents stress that this type of tax can lower market efficiency, because it reduces the informative role. According to some research, total transaction costs of trading corporate bonds range from 1% to 3.5% of nominal value.

¹⁶ Edwards, A.K., Harris, L.E., Piwowar M.S. (2005), "Corporate bond market transaction costs and transparency", *The Journal of Finance*, vol. 62.

¹⁷ Rules of Securities Commission's fees.

¹⁸ Rules on BSE tariffs.

Corporate Bond Market in Serbia

On all BSE markets, the costs of secondary trading of debt securities are 0.01% of the amount, and maximum 3,500.00 RSD. These costs are paid by BSE members who then charge them to their clients.

Table 2: Costs paid to CRHOV¹⁹

CRHOV access membership fee	240,000
CRHOV member training	10,000
CRHOV installation of user applications	10,000
Issuing a certificate for use of SMART ID card	3,500
Granting access to Beoclient in the web application	1,500
Assigning CFI code and ISIN number and drafting of solution	1,000
Registration of securities issue in CRHOV	15,000
Payment of coupons and annuities to the holder of financial instruments	0.05% per order
Principle payment of financial instruments	0.05% per order no more than 5,000
Request for payment of principle, coupon and annuity	5,000 per request

Source: Tariff rules of Central Securities Registry, Depository and Clearing House http://www.crhov.rs/pravna/regulativa/srpski/tarifnik/Pravilnik_o_tarifi.pdf, date of access [15.11.2012]

For a more precise determination of costs of corporate bond issue, the authors have turned to Erste Bank JSC Novi Sad, the only bank that publicly offered their corporate bonds. A request was sent to the bank to provide the authors with an estimate of their costs in order to determine the real price of issue. In a very professional cooperation, Erste Bank provided the authors with an estimate of most important issue costs. The following table was prepared by Erste Bank JSC Novi Sad.

Table 3: Costs of public offering of Erste bank bonds

Erste bank bonds/ pieces	Nominal value	Volume
210,000.00	10,000.00	2,100,000,000.00
COSTS		
Amount	Institution	Purpose
1,000.00	CR	award of CFI and ISIN
10,000.00	CR	emission accounts / emission registration
13,500.00	CR	balancing / per order for cap 1.500,00
10,000.00	CR	special report on customer
57,600.00	CR	notice and demand for payment of coupons
100,000.00	KomBank	balancing
4,200,000.00	SEC	approval of the prospectus - 0.2% of the value
0.00	BSE	organizing primary market segment
0.00	BSE	balancing fee
6,000.00	BSE	stock certificate
60,000.00	BSE	engaging in secondary trading
62,000.00	Politika	newspapers / advertising
0.00	Investing company	emision agent/ sponsor
4,520,100.00		

Source: Erste Bank JSC Novi Sad

Erste Bank particularly noted that the issuers do not have to opt for primary offering on the stock exchange, and that instead they can register stock through an investment company, which would multiply the expense item “payment bank, settlement”. In addition, sponsorship (which is not listed here) is a very expensive service. There is no market practice for it, but at authors’ request, bank experts were interviewed who estimated that agent or issue sponsor fee would probably be in the % of issue volume, with CAP of 30-50,000 EUR. The fee would be significantly higher if the issuer would hire a bank instead of a broker-dealer company. From the enclosed table it can be seen that Securities Commission fee has no upper limit (it has a lower limit of 250,000.00 RSD) and that it presents the highest cost (when there are no costs of investment company or investment bank). Also, the BSE currently does not charge for

¹⁹ First five points apply only to CRHOV members who are not issuers in Serbia. However, these are costs of issues that at least indirectly burden the issuer.

certain costs, but it plans to introduce them with the new tariff rules (those items have no amounts in the presented expense sheet).

Investors usually include transaction and total costs when structuring their portfolios. Their decisions depend on costs of entering the corporate bond market, as well as costs of exiting that market. Reduction of transaction costs for individual investors is realised when he starts investing in bonds fund instead of directly investing in the certain corporate bond portfolio. Then the costs of bid-ask spread and trade commissions become lower. Investment in funds also entails additional costs, such as management, administrative, entry and exit fees. Investment through funds is profitable when a small individual investor invests in developing markets, i.e. when he wants to internationally diversify his portfolio.

In analysing business operations of pension funds, the National Bank of Serbia did a mini study on transaction costs of institutional investors on the Serbian capital market. According to NBS report for second quarter of 2012, the biggest share in transaction costs of pension funds on capital market have broker fees and custody bank fees. Stock transactions have the highest costs on BSE, while the treasury bill trade has the lowest cost. According to NBS data, out of total transaction costs, 73% were born by management companies, and 27% by funds. Since at the beginning of management company operations, the volume of trading was relatively high, especially that of stocks on BSE, the transaction costs were the highest in that period. With the start of economic crisis, the activities of management companies subsided, and investments were directed towards safer instruments that also have lower costs. As of 2009, these costs begin to rise again as the result of reducing the funds on transaction accounts and redirecting them to treasury bills of the Republic of Serbia and gradually increasing the stock trading. Also, by increasing net assets, the value of fund transactions increase as well in absolute terms. At the end of 2011, there was a significant drop in transaction costs. The same trend continued in the first half of 2012 as well.

Table 4: Transaction costs of pension funds in Serbia

Amount of transaction costs (In million of RSD)							
	2007	2008	2009	2010	2011	2012	
						T1	t2
Total	10.0	5.3	7.4	9.7	7.0	1.3	1.1
Brokerage fees	4.5	2.2	3.8	4.5	2.9	0.6	0.4
Custodian bank fees	1.8	1.5	2.0	2.4	2.2	0.4	0.4
Stock Exchange fees	1.6	0.8	0.4	1.1	0.8	0.1	0.0
Central registry fees	1.0	0.6	1.2	1.5	1.1	0.2	0.2
Other expenses	1.1	0.2	/	/	/	/	/

Source NBS

3. Conclusion

Analysis of the corporate bond market in Serbia has shown that it is at the initial stage of development and that its capacity is almost negligible. A total of two public offerings have been registered. Issuers in both cases were banks. When it comes to the real sector, analysis has shown that issues of corporate bonds are very rare and that usually the issuers opt for closed issues to known investors, who have close contacts with the company and who are actually using the corporate bond only as an instrument to lend the money to the client.

Comparative analysis of experiences allows an estimate that a more serious development of corporate bond market cannot be expected in the near future. The main reasons are low absolute and relative level of the so-called precautionary savings, i.e. low capacity of investment and pension funds. Furthermore, experience shows that in conditions of significant capacity growth of contractual savings mechanisms, these investors prefer government bonds as an investment alternative. Generation of large-scale demand can be expected only once the capital flows are liberalised and the capacity of contractual savings mechanism considerably exceeds the supply of government bonds.

Investing in corporate bonds is still highly risky – issuers behave in a non-transparent way, rating agencies do not exist, and regulations for bankruptcy procedure do not provide a satisfactory level of protection to the creditor.

On the demand side of these instruments are usually institutional investors, especially insurance companies, who are allowed by relatively more flexible legislation. However, even these investors usually opt for government secu-

rities and they do not dare to make larger investments in long-term dinar assets. The state thus absorbs long-term contractual savings of citizens without leaving too much room for investments into private sector. The reasons for investors' preference to invest in relatively safer securities and other investment alternatives lie in systemic risks that come from continuously high inflation, macroeconomic instability, and high variability of dinar exchange rate. Due to illiquidity of the market, investors who are today investing in corporate bonds intend to keep the securities until maturity, because they are aware that they cannot count on secondary trade.

Analysis has shown that Serbia has modern regulations that are in line with EU directives. National regulatory body does not really have a lot of room for creative solutions. Still, it is legitimate to question the dynamic of adoption of the latest solutions "imported" from developed markets. The issuers themselves have a hard time handling the modern capital market mechanisms, which can be seen by frequent interpretation requests sent to the Securities Commission. Unfortunately, due to lack of market practice in Serbia, the regulator itself has opted for the conservative approach and, in the opinion of many market participants, is interpreting the regulations restrictively, thus preventing learning by trial and error.

Issue and transaction costs of corporate bonds are high, especially for smaller companies. A question arises whether smaller companies have any interest in issuing corporate bonds. In theory, such an interest could exist because it is exactly this group of businesses that have relatively unfavourable borrowing conditions. When it comes to larger issuers, besides costs they also stress excessive transparency requirements as an obstacle, which instead of promised benefits (cheaper access to capital, better reputation, etc.) in a highly non-transparent environment (in which both the government and competition behave non-transparently), usually bring only additional costs. When it comes to banks, the interest comes from the fact that these issuers are exempt from having a reserve requirement if they issue securities on a period longer than two years. In a situation where banks have increased demand for dinar crediting and when dinar borrowing from other banks is prohibitive, corporate bonds are proving to be a good alternative.

What can be done in the short term?

First, Securities Commission is recommended to take a relatively more flexible approach. That means that, when responding to market requests to interpret new regulation, instead of pointing out what "cannot be done", it should teach the market participants "how it can be done". For example, Foreign Investors Council noted with great approval the successfully held conference on capital market in April 2012, after which in May, due to numerous comments of various market participants, the Commission agreed to change its official opinion regarding the obligation to publish a takeover bid by the majority shareholders in the case of purchasing their own stock. Due to lack of domestic market practice, it is necessary to support the Securities Commission in acquiring additional experience in transition countries who are already applying the rules recommended by EU directives that we recently adopted.

Also, it would be necessary to lower the costs of issuing securities. In that sense, it is necessary for all institutions (CRHOV, BSE, Securities Commission) in cooperation with the state to coordinate revision of their tariff codes and to adjust them not to market conditions in the region, but to the Serbian reality. This does not mean that real costs of these institutions should be ignored, but that perhaps the state could strategically support the development of capital market by subsidising some of these costs.

Bibliography

- IMF Country Report: “Serbia and Montenegro: Serbia—financial system stability assessment, including reports on the observance of standards and codes on the following topics: monetary and financial policy transparency, banking supervision, and payment systems” (2006), Country report No 06/96.
- Law on Voluntary Pension Funds and Pension Plans (“RS Official Gazette”, no. 85/2005 and 31/2011).
- National Bank of Serbia Report on sector of voluntary pension funds in Serbia for the second quarter of 2012.
- Law on Insurance, revised text prepared based on the text of the Law on Insurance (“RS Official Gazette”, no. 55/2004) and its changes and amendments, that is, corrections published in “RS Official Gazette” no. 70/2004 – corrections 61/2005, 61/2005 – state law, 85/2005 – state law, 101/2007, 63/2009 – decision of the Constitutional Court, 107/2009 and 99/2011.
- Decision on restrictions of certain forms of depositing and investing technical reserve funds and on maximum amounts for individual deposits and investing required reserves of insurance companies (“RS Official Gazette”, no. 87/2012).
- National Bank of Serbia Report on insurance sector for the second quarter of 2012, August 2012.
- Law on Investment Funds (“RS Official Gazette”, no. 46/2006, 51/2009 and 31/2011).
- Law on Capital Market (“RS Official Gazette”, no. 31/2011).
- Business Report on Belgrade Stock Exchange for 2011.
- Business rules for Belgrade Stock Exchange JSC Belgrade (04/2 no. 3242-1/12).
- Listing Rules of Belgrade Stock Exchange JSC Belgrade (04/2 no. 3163-1/12.).
- White Paper, Proposals for Improving Business Environment in Serbia, Foreign Investors Council, 2012.
- Bankruptcy Law, (“RS Official Gazette”, no. 104/2009).
- Edwards, A.K., Harris, L.E., Piwowar M.S. (2005), “Corporate bond market transaction costs and transparency”, *The Journal of Finance*, vol. 62.
- Belgrade Stock Exchange JSC tariff code (04/2 no. 3165-1/12)
- Tariff Code (“RS Official Gazette”, no. 16/2012, 50/2012, 57/2012 – correction, and 68/2012)
- Tariff code of Central Securities Registry, Depository and Clearing House.