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Current Situation of the Corporate Bond Market of Mongolia and Proposed Solutions to the Challenges

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Abstract

One of the ways for the corporate financing is the long term debt issuance. However, the long term debt financing requires a great deal of responsibilities from an issuer and major risk involvement from buyers and investors. Debt financing is very common in developed markets where the payback guarantee is evaluated by the rating agencies. The bond rating itself reduces the risk and increases the trust of the investors and is conducted based on internationally accepted theories and techniques. Therefore, it is deemed crucial for the Mongolian debt market to develop the bond rating mechanism where the sound appraisal of the payback capabilities and solvency based on the international experiences is the key.

Keywords: corporate debt, corporate bond, rating, appraisal, evaluation, default risk, payback guarantee, solvency

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Introduction

The objective of the paper is to define the theoretical framework for the debt market rating, corporate bonds, the participants and their interconnected activities for the purpose of identifying ways to develop the efficient corporate bond market in Mongolia.

The extensive researches have been conducted in the field of bond rating since 1990 and can be categorized in 3 main groups.

1st group: Researches on the roles of bond rating, its weaknesses and disadvantages.
These papers studied the relationships between the bond ratings (AAA, AA, A etc.) and the solvency of the firms. Main representatives are Cantor *et al.* (2001).

2nd group: Researches on the effect of bond ratings to the securities market.
These papers are focused on the relationship between the bond ratings and the bond spreads (interest rates). Moreover, the effect of changes in bond ratings to the stock prices are studied. Main representatives are Norden *et al.* (2004), Parnes (2008), Jorion *et al.* (2009).

3rd group: Researches on the techniques to model the bond appraisal factors.
The papers are focused on the relationship between the firm financial indicators and the rating. Altman (1968) is the key contributor. This group also includes the papers on the relationships between the macroeconomic indicators and the bond rating. The representatives are Figlewsky *et al.* (2012). Starting from 2001, the utilization of rating and the rating system and procedure related researches are conducted extensively. This time the papers are focused mainly on the activities of the rating agencies and the key representatives are Becker *et al.* (2011), Doherty *et al.* (2012).

Additional recent studies are concentrated on “conflicting structure of profit” derived from the “Issuer-pay” model, plus the rating agency and rated firm behavior model “Rate shopping”.

Theoretical background

The firm financing theories are emergent from the Game theory (Neumann *et al.,* 1944). The game theory or so called information dissemination theory, which plays important roles in explaining economic behavior since 1970, explains the behavior of the participants of the financial market. The information dissemination theory, that is known as principal agent theory or agent theory explains the behavior of the economic agents and their primary incentives (Akerlof, 1970; Spence, 1973; Crawford *et al.*, 1982). The theory identifies relationships among the shareholders, board members, executive management and the managers. Adding to these relationships, the “Lemon market theory” identifies the third party as a bond rating agencies which are crucial in providing more relevant information in debt financing market. In other words, the rating companies provide the balance to the information inequality or difference between the investors and the issuer firms. This can be explained in 3 instances.

First, the rating firms operate as a third party, independent from the bond issuers or investors.

Second, the rating firms use their own techniques and know-how based on the professional studies for estimation of the probabilities for the principal and interest payment paybacks.

Third, the "information cost" can be reduced thanks to the rating firms. It is possible to reduce the information obtaining and processing costs while using the information from the rating agencies. In other words, the being the manufacturer of the information, the rating agencies can be regarded as one of the basis for the more efficient market.

Since 2000, the behavioral rules and institutional structures of the rating agencies were under more focused research (White, 2007; Möllers, 2009).

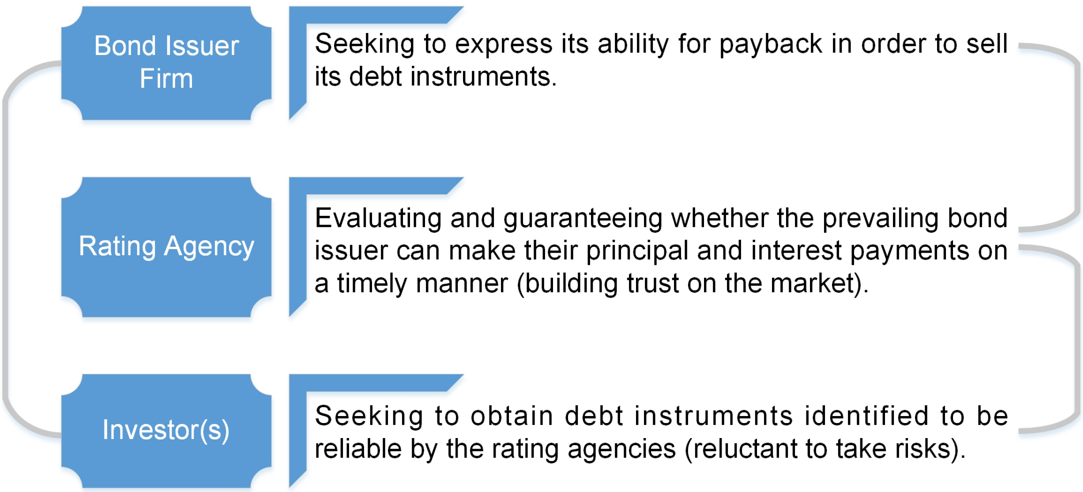
Theories behind these studies suggested that the rating agencies evaluate the default risk of the issuers based on their own structures and techniques, which in turn become the guaranteed standards of investors' trust. Also, the bond rating signifies not only the demand of the investors seeking to dissipate the information inequality in the market, but also responds to the demand of the bond issuers seeking continuous financing. For the investors, the default risk or the probability of principal payback on time is crucial. However, it is assumed that they pay a strong attention on the interest payback, as well. "Agent theory" connects the involved parties in a following manner.

Research section

Since the very first bond issuance that has occurred in Mongolia on June 08, 2001, the initial market saw the total of 19 billion tugrig worth of issuance from 14 different companies. "New century" bond, the very first bond on the market issued by the Barilga Corporation in 2001 was followed by another 13 successful bond trading on the initial market, which mainly issued by the construction companies. The last issuance by the "Erchim Engineering" LLC in Aug 2015 was guaranteed by the issurance company on default risk.

Today, the following procedures are required by the authorities for the bond issuance.

- The shareholders' meeting resolution for the approval of bond issuance and authorization of preparation of required documents.
- The documents are submitted to the Financial Regulatory Committee (FRC) for the approval.
- Once FRC resolves to register the instrument, the Mongolian Stock Exchange (MSE) is asked for the registration.



All the procedures follow the rules and regulations dictated by “The company law”, “Securities market law”, “Regulation for the registration of new securities offered to the public” by FRC, “Registration regulation” and “Trading regulation” by MSE. A company is required to commit to true presentation of document submission and guarantee the payments of principal and interests fully and on time. The bond issuance expenses are:

- FRC charge - 200,000 tugrig
- MSE registration fee - 0.1% of the total value of issuance
- In case if bond is registered and traded: Trading fee - 0.3% of total value of traded securities (including MSE, settlement and savings account center, broker and dealer company fees). In case if underwriter company is involved, the fee is set according to the contract and is typically 1.5-5.0% depending the total issuance value. Short, medium and long term bonds are guaranteed by the fixed assets and stocks.

From the investors’ side, the buying decision is based on the information provided by the MSE, FRC and the mediators.

In case of Mongolia, the companies in need of financing prefer more of short term bank loans instead of issuing securities on the market (Graph 1).

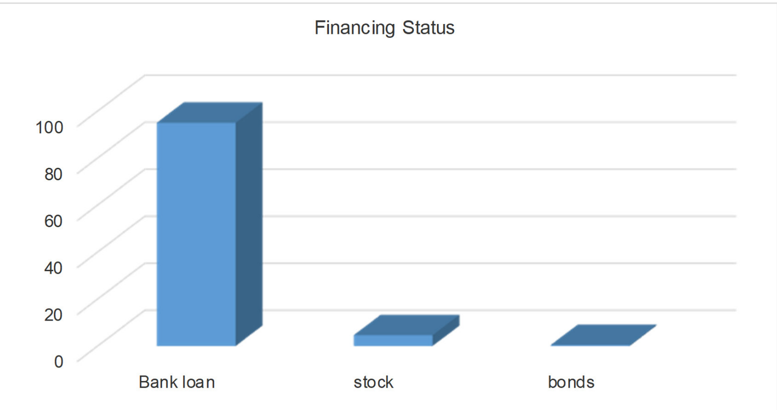
Since the start of the secondary bond market, there are cumulatively 781,933 new and 132,799 link accounts registered, out of which 777,609 belongs to Mongolian citizens, 1,745 are by foreigners, 2,407 are by domestic entities and 172 belongs to the foreign entities. In 2nd quarter of 2012, newly opened accounts in central settlement account are 6,610, of which 6,569 are by Mongolian citizens, 19 are by foreigners, 13 are by the domestic entities and 9 are by the foreign entities. Compared to the same reported period last year, the number of accounts registered is increased by 6.4% (FRC report-1st Quarter 2015).

Conclusions

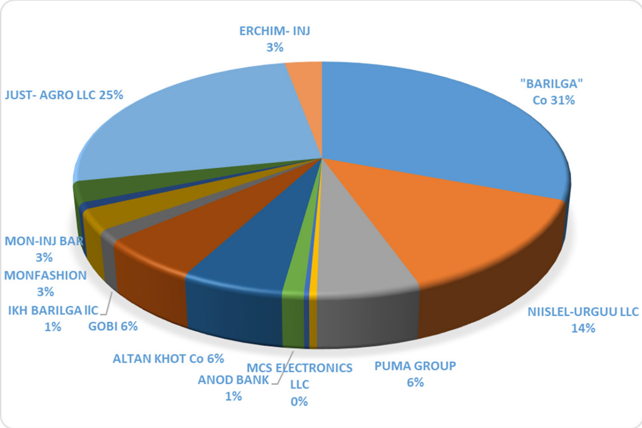
Even though Mongolia has taken the path of the market economy for the last 25 years, the securities market and especially the bond market is weakly developed so far. The private sector financing is heavily dependent of the non-direct bank financing, which brings many difficulties via higher interest rate, stricter financing requirements and more collaterals. Hence, the financing possibilities are greatly reduced despite more opportunities in business fields.

There are discrepancies of information (information inequality) in the securities market between the issuers and buyers/investors and this problem can be addressed properly by the “rating entities”.

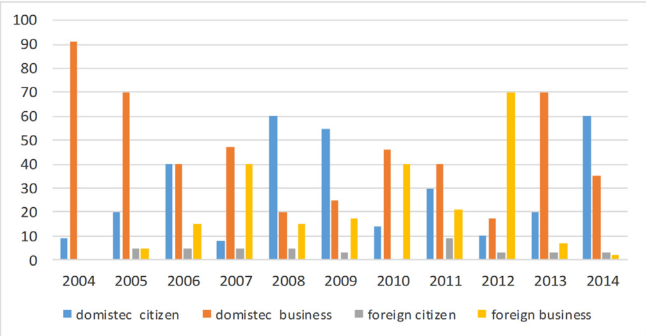
Graph 1. Total private sector financing (excluding equity financing)



Graph 2. Companies financed by a bond



Graph 3. Participants in the securities market, by categories (MSE online source)



It can be stated that the weak development of securities market is due to lack of professional and specialized rating agencies who evaluate bond default risks. Therefore, it is deemed necessary to study the theories and practices concerning rating activities, the development and challenges worldwide. The theoretical essence of the bond rating is the agency theory, widely recognized and utilized in many other economic and business fields.

Main reasons behind slow development of bond market are, from perspective of bond issuers:

1. Lack of knowledge and information in bond financing.
2. Article 16.4 from the Securities market law. "The total value of the debt instrument to be issued by a company shall not exceed the company's equity value; as well as the total value of the debt instrument issued by a company with a third party guarantee shall not exceed the sum of the equity value of that company and the guarantee amount made by a third party".
3. Learned to apply to the banks. Majority of Mongolian companies tend to prefer domestic and foreign bank loans which negatively affect the growth of bond market.

Reasons from the perspective of investors:

1. The bank interest rate is high. Average annual rate is 15-16%.
2. The true statements and factual information of the company lacks and obtaining them costs more and time consuming.
3. The payback is uncertain and trust level is very low.
4. Methods and techniques in estimating default risk and payback capabilities are practically nonexistent in Mongolia.

Proposals

Assuming that the securities market is the relationship based on the proper and truthful information and the trust of participants, the "rating entity" mediates and functions to build trust through providing meaningful estimations and information on issuers. The followings are the proposals for the stronger bond market development.

- Establishment and support of rating

entities/agencies and adopting standard appraisal methods and techniques in practice. It means the introduction of new financial service industry as a whole for the need of investors.

- Considering the lack of knowledge and information about the securities market, building of public awareness through conduct of research and trainings is in importance.
- Truthful presentation, transparency and information disclosure from the companies are required with the support of proper legal and procedural framework.

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