Working Paper: The Crisis in the Corporate Bond Market in Israel and Pricing of Risks in the Primary and Secondary Markets in 2008-2010

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Abstract

The study examined whether there were failures in the development of the corporate bond market, its structure and risk management practices. The first chapter examined the manner in which the tradable financial markets in Israel evolved – in the years prior to the crisis, in relation to other countries – for the purpose of understanding why in other countries the crisis was mainly in real estate and banking, while in Israel – mainly in the corporate bond market. The second chapter of the study examines the characteristics of the bond market and the manner in which risks were priced prior to the crisis. The third chapter deals with models which attempt to estimate the probability that a company will reach a debt settlement agreement or encounter financial difficulties, based on accounting data made public. The fourth chapter includes a summary and recommendations.

The study's main findings are as follows: the share of the real estate industry in the corporate bond market is minimal worldwide, but in Israel, this was the industry which raised the most debt in the years that preceded the crisis. As a result, the corporate bond market constituted one of the main focal points of the crisis. However, an in-depth assessment of the crisis reveals that so far, the corporate bond market in Israel was less compromised than other bond corporate markets around the world. In addition, the percentage of insolvent corporate bond companies around the world was higher than in Israel as of the first half of 2010.

In Israel, as elsewhere, underpricing of risks in the bond market was evident in the years that preceded the crisis. However, the pricing of the various risks in the primary market was usually adequate. In addition, issues such as duration, rating and industry were correctly priced by the market. Overall, it is safe to say that the market's risk pricing formula included the relevant variables. But when reviewing the familiar models, from the literature, for forecasting insolvency of a company based on financial ratios, the study found that the models were unable to produce adequate forecasts as to which companies in Israel would become insolvent. The results were improved when the measure was adapted to the Israeli market.

The study reviewed the variables which influence the probability of a company becoming insolvent in the real estate industry, yielding that entrepreneurial real estate companies had a higher probability of reaching insolvency in relation to income generating real estate companies. The use of redemption yields when estimating insolvency probabilities provides results which are on par with those of the model based on financial ratios. At the height of the crisis, risk was evidently overpriced. Nevertheless, the relative pricing was correctly done, managing to separate between companies which would encounter solvency difficulties and those that would not.

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