ISSUES

PACIFIC ECONOMIC COOPERATION COUNCIL

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Developing Bond Markets in the APEC Region:

Need and Agenda for Public-Private Sector Partnership

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About this Issue

This **ISSUES@PECC** summarizes the findings from the discussion on *Assessing and Building Capacities for the Development of Bond Markets in the APEC Region*, at the 3rd Annual Conference of the PECC Finance Forum held in Santiago, Chile, on June 20-21, 2004.

The PECC Finance Forum serves as an open forum for a tri-partite dialogue among the academia, government and business sector, on the financial policy issues facing the Asia-Pacific region. The purpose of the dialogue is to assess the international environment for financial stability and development in the region, the progress in the promotion of financial reforms, integration and cooperation in the region, and to develop the desired vision of regional financial and monetary cooperation. For the purpose of these assessments, the Finance Forum undertakes survey-based task force studies on specific issues as well as convenes an annual conference of experts drawn from the member economies and international financial institutions.

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The Pacific Economic Cooperation Council (PECC) was founded in 1980 to serve as a forum to discuss cooperation and policy coordination in the Pacific Region. PECC's expert networks composed of analysts, officials and businessmen provide practical policy advice on trade, finance, and sectoral issues to the region's governments. PECC is the only non-government official observer of the APEC process. See: http://www.pecc.org for more details.

INTRODUCTION

Recent policy initiatives by various regional fora have focused attention on the issue of developing the region's bond markets. The 1997-98 financial crisis made clear the potential role of long-term local currency bond markets in avoiding the "double (maturity and currency) mismatch" problem that greatly contributed to its occurrence, and in diversifying sources of debt financing within the economy. Efforts by Asian governments to promote the growth of their respective domestic bond markets have gathered pace since then.

Domestic bond markets are important for a number of other reasons:[1]

- They provide greater investment opportunities for financial institutions and retail investors.
- They help deepen markets by attracting reputable foreign investors.
- They provide an alternative source of funds whenever banks, which dominate most of the region's financial markets, are unable to help.
- Domestic bonds broaden capital markets, leading to a more efficient pricing of risk.

Robust bond markets also represent a fundamental solution to problems arising from increased capital flows to emerging Asian economies. These problems involve deepening conflicts between monetary and fiscal policy objectives, which result from overdependence on short-term debt instruments for sterilizing capital inflows.[2]

More recently, there have been efforts to promote the emergence of an Asian regional bond market.[3] These efforts involve many and complex challenges. Most of the region's emerging bond markets are still at the early stages of development. While the amount of bonds outstanding in local currency has grown substantially in recent years, maturity profile, securitization, market turnover and pricing valuation need improvement to attract investors to these markets. Much still needs to be done to

[1] John Farrell, *Development of Bond Markets: A Public/Private Sector Partnership* (Paper presented at the 3rd Annual PECC Finance Conference "Institution-Building in a World of Free and Volatile Capital Flows: PECC Perspectives," Santiago, Chile, June 20-21, 2004).

[2] S. Ghon Rhee, *Domestic Policy Challenges of Managing Capital Inflows* (Paper presented at the 3rd Annual PECC Finance Conference "Institution-Building in a World of Free and Volatile Capital Flows: PECC Perspectives," Santiago, Chile, June 20-21, 2004).

[3] The Asia-Pacific Economic Cooperation (APEC) Finance Ministers initiated regional cooperation to develop securitization and credit guarantee markets. The Association of Southeast Asian Nations (ASEAN) Plus Three grouping established working groups to address key areas in the development of an Asian bond market. The Executives' Meeting of East Asia Pacific Central Banks (EMEAP) launched a US$1 billion Asian Bond Fund (ABF). The members of the Asia Cooperation Dialogue (ACD) committed themselves to support these initiatives.

develop the legal, regulatory and financial infrastructure in order to support the growth of bond markets.

KEY INGREDIENTS FOR BOND MARKET DEVELOPMENT

In support of regional efforts, the PECC Finance Forum conducted a number of discussions on the issue of bond markets involving the private sector, in addition to academe, multilateral development institutions and government and regulatory agencies.[4] From these discussions, the Finance Forum has identified a number of key ingredients for accelerating the development of bond markets in the region and expanding the participation of private sector investors and issuers.

For Domestic Bond Markets

Any effort to stimulate the emergence of a regional bond market needs to start with reforms to develop and strengthen domestic bond markets. The following are the key ingredients for the development of these markets:

1. The experiences of economies where bond markets have rapidly developed in recent years underscore the importance of simultaneously developing three fundamental elements: the width of the market (the variety of product types), the depth of the market (the robustness of the investor base, including development of pension funds and the retail investor base), and market infrastructure (which include complete systems for bond trading, clearing and settlement, as well as hedging and credit rating systems).

2. Bond market development requires effective coordination among government agencies as well as close public-private sector partnership. In many emerging markets, banks are the major sources of finance and the most significant players in bond markets, and should be involved in the early stages of bond market development.

3. Regulation should focus on maintaining and enhancing transparency, which is important for the soundness of market-based structures with multiple participants such as bond markets, and market integrity, which is important for investor confidence. This involves maintaining a robust system of clear, complete, timely and meaningful disclosure; promoting good corporate governance; as well as formulating and strictly enforcing clear and sound market rules and regulations.

[4] The PECC Finance Forum recently organized together with the APEC Business Advisory Council (ABAC) and in partnership with the Asian Bankers' Association (ABA) and the Association of Credit Rating Agencies in Asia (ACRAA) a conference involving 145 leading representatives from the region's major financial institutions. This conference sought to develop private sector inputs into the work of APEC in the development of bond markets, upon the request of the APEC Finance Ministers. An early draft of the conference report was presented during the PECC Finance Forum's 3rd Annual Conference in Santiago, Chile. See Julius Caesar Parrenas and Kenneth Waller, *Developing Bond Markets in APEC: Moving Forward through Public-Private Sector Partnership* (Report of a Conference Jointly Organized by ABAC and PECC, May 10-11, 2004, Taipei).

4. Markets will attract investors if there is competition among market participants and if they are open to many players, both domestic and foreign. Such conditions ensure that market prices for risk are properly reflected and provide fair returns. Ideally, jurisdictions should have a competition regulator with full authority to intervene where it considers that market activity is being conducted in an anti-competitive manner.

5. Taxation treatment is highly influential in market players' decisions, and should be reviewed to determine whether they are conducive to the holding and trading of bonds. It is an important factor in the growth of repo markets[5] and in market liquidity.

6. Where economies are unlikely to generate the scale needed to provide liquidity and depth, special measures to support long-term financing should be considered. An example is the model followed by Korea in the use of collateralized bond obligations (CBOs).[6]

For Regional Bond Markets

Given their small size, most of Asia's bond markets face serious limits to liquidity, efficiency and growth. For this reason, the region's economies would benefit from greater cross-border issuance and investment and the eventual development of a commercially driven regional bond market. Such a market would enable companies and public entities to more directly tap the huge savings within the region. It could also attract international investors, by providing wider market choice, diversification of risks and higher returns.

A regional bond market would require - in addition to fundamental measures to strengthen and develop domestic bond markets as mentioned above - a number of measures, which are as follows:

1. Cross-border investment and trading in bonds would require the eventual opening of capital accounts and more flexible exchange rate arrangements. However, these measures also entail putting a number of necessary reforms in place to strengthen financial systems

[5] In the case of Chinese Taipei, tax exemption has been crucial in investors' decisions to enter into repo contracts and in the creation of a sizeable repo market, which was a major mechanism in promoting liquidity and broadening local bond market participation. Albert S.T. Ding, *Evolution of the Chinese Taipei Corporate Bond Market* (Presentation at the ABAC/PECC Conference "Developing Bond Markets in APEC: Moving Forward through Public-Private Sector Partnership," May 10-11, 2004, Taipei).

[6] This involved the pooling of bonds issued by companies into combined issues, which became Primary CBOs, during the time when the collapse of the Daewoo Group in 1999 and the financial deterioration of the Hyundai Group in 2000 made it very difficult for firms to raise funds. The Korea Credit Guarantee Fund provided credit enhancement for these issues. Senior tranches were sold to investors in the market, while higher-risk subordinate tranches were repurchased by the issuers. Primary CBOs issued by small and medium companies in 2000 have mostly been redeemed, and have proven successful for both investors and issuers. Dong-Soo Choi, *Developing Bond Markets in Asia, the Role of Credit Enhancement and Lessons from Korea's Experience* (Paper presented at the ABAC/PECC Conference "Developing Bond Markets in APEC: Moving Forward through Public-Private Sector Partnership," May 10-11, 2004, Taipei).

against the risks posed by volatile capital flows.

2. Regional policy coordination and cooperation is required to address a number of interlocking measures, including the harmonization of market infrastructure and practices, including insolvency regimes, credit rating practices and accounting standards. APEC should play a role in this process, with the support of international financial institutions and the involvement of the private sector.

3. Credit enhancement facilities at domestic and regional levels could play important roles in the financing of small and medium enterprises. Market players believe that the impact of using public resources for regional credit enhancement mechanisms would be greater than if they were used to merely stimulate demand. However, such facilities should reflect the market price of capital.

CAPACITY-BUILDING IN KEY AREAS

To accelerate the development of domestic bond markets and the emergence of a regional bond market, governments need to intensify regional capacity-building efforts in partnership with the private sector. Particular areas where APEC regional cooperation could play a significant role include the following:

1. Expanding the region's institutional investor base. APEC should undertake policy dialogue and cooperation among its member economies and the private sector to encourage broader cross-border investment by institutional investors in domestic bond markets. These efforts should focus on (a) ensuring that tax regimes are attractive to domestic and foreign investors; (b) adoption of internationally accepted standards on documentation and practices in markets; (c) transparent processes and conducive environment for assessing risk and return in traded instruments; (d) regulations to promote efficient markets and settlement systems; and (e) issuance of bonds in sufficient sizes to attract wider investor participation.

2. Developing a strong regional credit rating industry. APEC should lend greater support to ongoing capacity-building efforts to harmonize credit rating practices in the region with global standards and to develop best practices in local credit rating agencies. Member economies should work toward harmonizing regulations governing the operations of credit rating agencies, with the objective of ensuring high quality of credit ratings throughout the region. Global credit rating agencies have an important role to play in deepening the understanding of credit culture and the role of credit ratings in capital markets among policy makers and market players.

3. Promoting effective domestic and region-wide insolvency and creditor rights systems. APEC should promote, in coordination with key financial sector organizations, (a) legislation in member economies to enable the recognition of

insolvency administration across jurisdictions; (b) region-wide acceptance and application of sound principles and methodologies that support informal workout techniques; and (c) common approaches to the coordinated development of secured transactions and insolvency law regimes in member economies. In addition, APEC should undertake capacity-building efforts to improve the framework for debt collection and arbitration through the region.

4. Promoting region-wide convergence toward global accounting standards. The International Accounting Standards Board (IASB) has recently developed the International Financial Reporting Standards (IFRS) as a single set of global accounting standards. APEC can play an important role in addressing a number of major issues in this area, in particular the capacity of developing economies to address technical impediments to convergence. APEC should establish a regional forum of domestic accounting standard-setting bodies from member economies to provide broader regional inputs into the ongoing work of the IASB. In addition, the APEC Finance Ministers should establish a policy initiative on convergence, involving the regional forum of accounting standard-setting bodies and the private sector, to develop a regional convergence plan and to undertake capacity-building measures.

POLICY CHALLENGES

The process of promoting the emergence of a regional bond market is not only difficult and complex, but also involves risks that need to be managed and addressed. Foremost among these are the risks arising from greater cross-border capital flows as a result of capital account opening and harmonization of tax and legal regimes and market practices, in advance of the development of regional financial markets.[7]

On one hand, the Asian crisis has demonstrated the dangers of capital account liberalization and measures to promote cross-border capital flows in an environment of underdeveloped financial markets, weak market discipline, moral hazard and inadequate supervision and governance of financial institutions. On the other hand, a regional bond market cannot emerge without open capital accounts. This consideration underscores the importance of strengthening domestic financial systems and market infrastructure as an essential requirement for the development of a regional bond market. In any case, related efforts to promote greater transparency, more efficient clearing and settlement systems and stronger creditor rights, among others, would help accelerate the development of robust domestic bond markets that would form the foundations of a future regional bond market. In addition,

[7] Barry Eichengreen, *The Unintended Consequences of the Asia Bond Fund* (Paper presented at the 3rd Annual PECC Finance Conference "Institution-Building in a World of Free and Volatile Capital Flows: PECC Perspectives," Santiago, Chile, June 20-21, 2004).

sound macroeconomic and fiscal policies need to be maintained to provide a conducive environment for market growth.

There are also risks that could arise from government efforts to promote bond markets, where these might create moral hazard and distortions to capital pricing, and in the process make the environment less conducive to financial stability. It is therefore important for governments to avoid subsidies that lead to such situations, and for special measures such as credit enhancement facilities and regional bond funds to be carefully designed to reflect the market price of capital.

The recent experience of Hong Kong provides an outstanding example of public-private sector collaboration to promote bond market development without the involvement of subsidies. Starting in 1999, public firms issued a number of retail bonds in coordination with private financial institutions, which provided advice and distribution and issued retail bonds of their own. Today, over HKD30 billion have been issued by public and private entities, making the market deeper for the private sector to use, even as the first securitization of government-owned assets aimed at both retail and institutional investors has been launched.[8]

There is a need to continue studying some proposals designed to accelerate the emergence of a regional bond market in Asia. One of these is the creation of Asian currency basket bonds issued against an underlying pool of local currency denominated bonds aimed at regional investors. Such bonds would require considerable infrastructure for implementation and a long time to develop. Investors also believe that it would be difficult to understand the risks involved. Further study is needed to determine whether and how such bonds could be made more attractive to investors.

Another proposal is the creation of a regional credit rating agency or a similar mechanism in Asia. There is a valid argument for regional credit ratings, given the situation in Asia, where few companies are rated and where ratings are currently compressed under sovereign rating ceilings at the lower end of investment grade or below.

However, a number of obstacles to the efficient operations of a regional rating agency need to be addressed. These include the lack of regional default studies and of harmonized regimes in financial reporting, insolvency law and taxation regimes. Contentious issues related to ownership structure, management control and area of operation need to be sorted out. Investors believe that private ownership is necessary for any credit rating agency

[8] Anita Fung, *Case Studies of Successful Public-Private Sector Partnership: New Markets - Retail; New Instruments - Asset Backed Securities* (Presentation at the ABAC/PECC Conference "Developing Bond Markets in APEC: Moving Forward through Public-Private Sector Partnership," May 10-11, 2004, Taipei).

to be credible and commercially viable, and that it takes time for any credit rating agency to earn trust within the market.

Given these difficulties, it would be more practical to prioritize the harmonization of rating practices among local credit rating agencies in the region to make their credit ratings more comparable and easier to understand by regional and global investors.

CONCLUSION

The development of domestic bond markets in the region is still for the most part in its early stages. A commercially driven regional bond market involving APEC member economies is still a long way off. There are compelling reasons to accelerate the development of these markets by simultaneously addressing the many complex issues involved in this process.

There are no short cuts to bond market development without strengthening financial systems, most especially the banking sector, which still plays the dominant role in most developing economies in the region. Domestic financial reform is an important requirement for the effectiveness of efforts to develop capital markets and to promote cross-border capital flows.

For the success of any effort to develop strong domestic bond markets and - building on these foundations - to promote the emergence of a regional bond market, strong leadership and firm commitment of relevant governments, reflecting the views of the private sector, are essential. In this context, the PECC Finance Forum hopes to contribute to broadening and deepening public-private sector partnership in cooperation with the APEC Finance Ministers' Process and other regional institutions, to promote the growth of domestic and regional bond markets.

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