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Fostering Bond Markets in Asia

- How to make the Asian Bond Markets Initiative successful -

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Intensifying debates on Asian bond markets

Active debates on Asian bond markets are currently taking place in various regional forums. The EMEAP (Executives' Meeting of East Asia and Pacific Central Banks), which was formed by Asian and Oceania central banks, agreed to create the Asian Bond Fund (ABF) to invest in bonds issued in the region. At the same time, the Asian Bond Markets Initiative (ABMI) was introduced by the finance ministers of ASEAN + 3 and was actively discussed at the meeting of ASEM finance ministers held in Bali on 5-6 July. These proposals are yet to be shaped into concrete forms and will require more time to be put into operation. However, these are positive signs that, six years after the eruption of the Asian financial crisis, Asia is slowly but surely on its way putting sturdier market structures in place.

The current debates cover a wide range of issues and include various critical aspects. If they are dealt with in an orderly fashion and appropriate policies are implemented, efficient bond markets will be created in Asia, a region which boasts affluent savings. The initiative for bond markets in Asia is a grand financial infrastructure scheme for the region, and time and thought should not be spared.

I would like to give a constructive review of why the debates on Asian bond markets are now on the rise and what influence these debates, such as on ABMI, would have on regional bond markets. Then I will move on to the requirements for implementing these initiatives successfully.

Review of the Asian financial crisis and the securities markets

The Asian financial crisis, which brought much suffering throughout the region, illuminated the importance of cooperation among the countries in the region in dealing with various issues. This recognition lead to the creation of East Asian regional financial cooperation frameworks such as the Chiang Mai Initiative by the ASEAN + 3. As a result, a network of bilateral swap arrangements has been established, thereby creating a system to provide liquidity at a time of crisis.

One of the reasons, which caused the East Asian financial crisis, was the over-dependence of private corporations on short-term dollar funds for their capital investment due to a lack in long-term local currency funds because their capital markets were underdeveloped. Once the dollar-pegged system, which many of the Asian countries had implemented, collapsed due to speculative attacks, many private companies and financial institutions were hit by foreign exchange losses as the dollar appreciated against their home currencies. At the same time, their borrowings had short maturities and it became impossible for these private institutions to repay them. They were caught in the so-called dual mismatch, in currency and maturity.

Developing corporate bond markets, so that long-term funds denominated in regional currencies can flow in abundance to the local private sector, is a significant step towards decreasing the mismatch of currency and maturity, and creating a strong economy that can defy future crises. Hence, the countries in the region have been making serious efforts to develop bond markets. Because these economies tended to enjoy fiscal surpluses, government bond markets tended to be underdeveloped until the Asian financial crisis. But as a first step to develop corporate bond markets, government bond markets began to be developed to establish yield curves, which are indispensable for the development of corporate bond markets. Settlement systems, which are prerequisites for smooth securities transactions, are also being developed. As a result, government bond markets have seen much progress due to the strenuous efforts by the governments and liquid markets are materializing in many of the countries in the region. But corporate bond markets are only just beginning to be tackled. ABF and ABMI initiatives are efforts to combine national frameworks and the ASEAN +3 framework, created by the Chiang Mai Initiative, to develop bond markets in the region.

Two approaches; the ABF and the ABMI

ABF, which was initiated by the EMEAP, is a scheme to pool US$ 1 billion of the foreign reserves of central banks to invest in dollar denominated government bonds issued by Asian governments, switching from the portfolio dominated by US Treasury bonds. The aim is to purchase bonds denominated in Asian currencies in the future. If the ABF operates in a flexible manner, it may have a significant impact upon the relatively small amount of US dollar-denominated bonds issued by Asian governments in international capital markets.

The ABF can be seen as a top-down approach aimed at developing national bond markets by first developing a regional international bond market.

On the other hand, the Asian Bond Markets Initiative (ABMI) initiated by the ASEAN + 3 finance ministers is one that strives to strengthen individual national bond markets uniformly under a regional framework. This initiative foresees the development of an Asian bond market based on a strengthened edifice of national bond markets. This is a comprehensive scheme, and it is important to review the components in order to have a better understanding of the development of Asian capital markets.

The purpose of the ABMI is to nurture highly liquid bond markets which are user-friendly to both bond issuing companies and investors by increasing the number of bonds issued and to do so in a wide variety of currencies and with a broad range of maturities. The ASEAN + 3 countries should cooperate closely to study diverse, related issues in a comprehensive way, including long-term measures.

The following are suggested areas for consideration: 1) active issuance of sovereign bonds to establish benchmarks, 2) promoting bond issuance by governments and government agencies and the on-lend of the proceeds by extending loans to the private sector, 3) issuance of asset-backed bonds and utilization of guarantees for this purpose, 4) issuance of bonds denominated in local currencies by international organizations and governments, 5) bond issuance in host countries by companies making foreign direct investments, 6) diversification of the currency denomination of bonds and the use of baskets of currencies.

The following suggestions are made to create the appropriate environment: 1) utilization of guarantees, 2) establishment of regional rating organizations, 3) dissemination of information on regional high-performance companies, 4) strengthening of the settlement system, 5) regional technical support. In order to study these questions in depth, working groups have been set up as part of the ABMI on six major areas, such as the issuance of bonds denominated in Asian local currencies by international organizations and multilateral corporations, securitization and credit guarantees.

Looking at the ABMI closely, one realizes that its basis lies in strengthening the bond markets of member countries and in creating efficient markets. I would call this a bottom up approach.

Efficient bond markets must encompass a mobile primary issuance market, a fluid secondary market, transparent rules and regulations, tax system, market rules, well-functioning settlement and custody systems and a trustworthy rating system. How will the ABMI fare in each of these respects?

Efficient primary market and liquid secondary market

Bond markets are, by nature, different from bank loan markets in that bond markets allow investors to sell and collect the capital as they wish. Unless the investors' need for liquidity is met, bond markets will not function.

Admittedly, there are bond investments without regard for liquidity, such as some private placement bonds. For example, the so-called structured bonds, a form of private placement bond, with certain unique characteristics, are nearly impossible to sell. There are exceptions to every rule. But the basic principle of bond investment is that investors can sell and collect capital as they wish. This fundamental point should not be forgotten when discussing Asian bond markets. As for the improvement of liquidity, strengthening of the domestic bond markets will certainly be a significant factor.

The ABMI cites the improvement of liquidity as a major objective and places significant emphasis on its realization. As I have already mentioned, regional governments have been working to make their sovereign bond markets more efficient after the Asian financial crisis. The ABMI endorses the active issuance of bonds by governments and international institutions in order to make bond markets more efficient. To have government bond markets serving as benchmarks is a necessary prerequisite for fostering corporate bond markets. Asian countries have been issuing more bonds since the crisis to deal with non-performing loans, but some governments may find themselves in the situation where their funding requirements are declining. Some method must be devised for such circumstances so that these governments can maintain the balance of government bonds, which serve as benchmarks.

The initiative to open domestic bond markets to non-residents and international institutions and to use those bonds issued by international organizations to further reform domestic bond markets can be an effective way to make these markets more efficient. So the ABMI takes a flexible position on the issuance of bonds by international institutions and foreign government agencies in domestic bond markets along with government bonds. Such bond issuance can be expected to enlarge investment opportunities and to increase the liquidity of bond markets.

It would also be beneficial for companies that make foreign direct investment to issue long-term bonds in the host country. For companies investing abroad it is critical to secure investment funds for long-term facility needs. Bond issuance by such companies should be encouraged, and that will also contribute to the advancement of the host country’s markets.

The principles of the ABMI, I believe, will contribute to fostering efficient primary issuance markets and liquid secondary markets.

Governance and market infrastructure

Wide-ranging reforms of the infrastructure that support bond markets, i.e. the issue of governance, should be dealt with as a regional issue.

The aim of nurturing capital markets is to foster corporate bond markets. In order to do so, reform of corporate governance is the key issue. How can transparency of the whole market be enhanced? The answer involves governance of issuers, governance of investors, governance of markets, among other issues. For example, it is a continuous and significant issue for Asian countries to enhance the transparency of financial statements. Since, unlike bank loans, bond markets operate by selling bonds to an unspecified number of investors, transparency is a critical issue.

The ABMI tries to deal with securitization of assets and related guarantee issues. Agreement has been reached to establish a regional guarantee facility in Asia and symposiums have been held to discuss the role of guarantees and its limitations. It is true that currently there are hardly any corporations in Asia that can issue bonds without guarantees. But on the other hand, it is important to limit guarantees to the minimum. Governance will not be enhanced by obscuring credit risks with guarantees. Various methods such as partial guarantees, guaranteeing of only the matured portion and other measures should be considered. To sell securitised assets to institutional investors, the ABMI includes various carefully considered ways to design products with acceptable risk profiles. These ideas must be promoted.

Although not part of the ABMI, fostering Asian investors is also an important aspect. In Asia, savings are continuing to grow and institutional investors, like pension funds or insurance companies, are accumulating more experience. It is very important to nurture such institutional investors, which include public and private institutions. Large scale public institutions tend to take advantage of their nearly monopolistic position and create the problem of not necessarily disclosing their investment evaluations fully. Nor are their investment decisions often transparent. Such investor governance issues must be tackled within the region. There are also unnecessary levels of restriction on investors, while on the other hand, there is the problem that there are not enough investment opportunities.

Rating agencies support investment activities and, as the ABMI asserts, it is necessary for Asia to have its indigenous rating organization. Only a rating organization that is closely attached to and has an intimate knowledge of the region can conduct effective rating. Rating is not just a matter of knowing how to rate institutions. Risks associated with investors depend essentially on their background. So should the risks be evaluated as the same when American investors and Japanese investors buy the same Asian bonds?

In order to encompass these wide-ranging issues, the ABMI lists technical support as one of the items for consideration. I do hope that there will be extensive debates, including the securities settlement system in the region, and that there will be technical support for necessary areas.

To realize a truly bottom up approach

What would the promotion of ABMI bring? First, if bond markets in the Asian economies are strengthened through the ABMI, then investment in the region will become more active. New products could also be introduced. The ABMI raises the possibility of selling securitized trade credits of ASEAN countries in the Tokyo offshore market. Then there is the expectation that such a regional effort will further push reform in the securities markets in individual Asian countries. If bond issuance and investment become more active in the region, this will bring, among other things, progress in the standardization of markets. Settlement and custody system is likely to make progress as well.

It is important that these efforts should progress with full use of the private sector, its knowledge, personnel and funds. In Europe, which leads Asia in the effort to create a shared securities market, the views of the private financial sector are always extensively reflected in the EU's drafting process. This is quite natural because the private sector is responsible for the complicated securities transactions, settlement and product design, and any draft that does not fully take the private sector into account is not be viable.

Japan has the potential to play a major role in fostering Asian bond markets. First, Japan has abundant experience. Japanese capital markets developed under a financial system dominated by banks, just like the experience many Asian countries are currently going through. We cannot say Japan's experience is a history of successes. There have been many failures along the way. For example, although altering the bank-centered system has been advertised as the key aspect in developing corporate bond markets since the 1960s, there has basically been no change in the bank-centered indirect financing system, and there has hardly been any progress. Asian countries can learn from Japan's failures as well as its successes in developing their corporate bond markets. There are cases where the vested interests that were created by the financial sector over the years, such as the long term banking system, have slowed down the process of modernization. On the other hand, Asian countries may learn valuable lessons from Japan's recent experience in developing the government bond and the settlement system.

Japanese efforts to implement the ABMI have so far been mostly government-led. It is worrisome that there is not much private sector involvement. One of the reasons for this could be that the Japanese financial sector is worn out by its efforts to cope with domestic non-performing loans. But Asia is surely the region that will lead the rest of the world in terms of growth in the coming years. Unless there is enough investment in the region, how can Japanese pension funds secure high returns when the country is burdened by the ageing society? It is necessary for the private sector to respond to and to cooperate with government initiatives because the ABMI raises the possibility of creating various business opportunities for the private sector. I have called the ABMI a bottom up approach. I hope that Japanese banks, securities companies and corporate investors, in cooperation with other Asian private institutions, will recognize the business opportunities and that they will participate enthusiastically. That will be the true bottom up approach.

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