Bond Market Development in ASEAN Countries (II)

Introduction of Bond Finance

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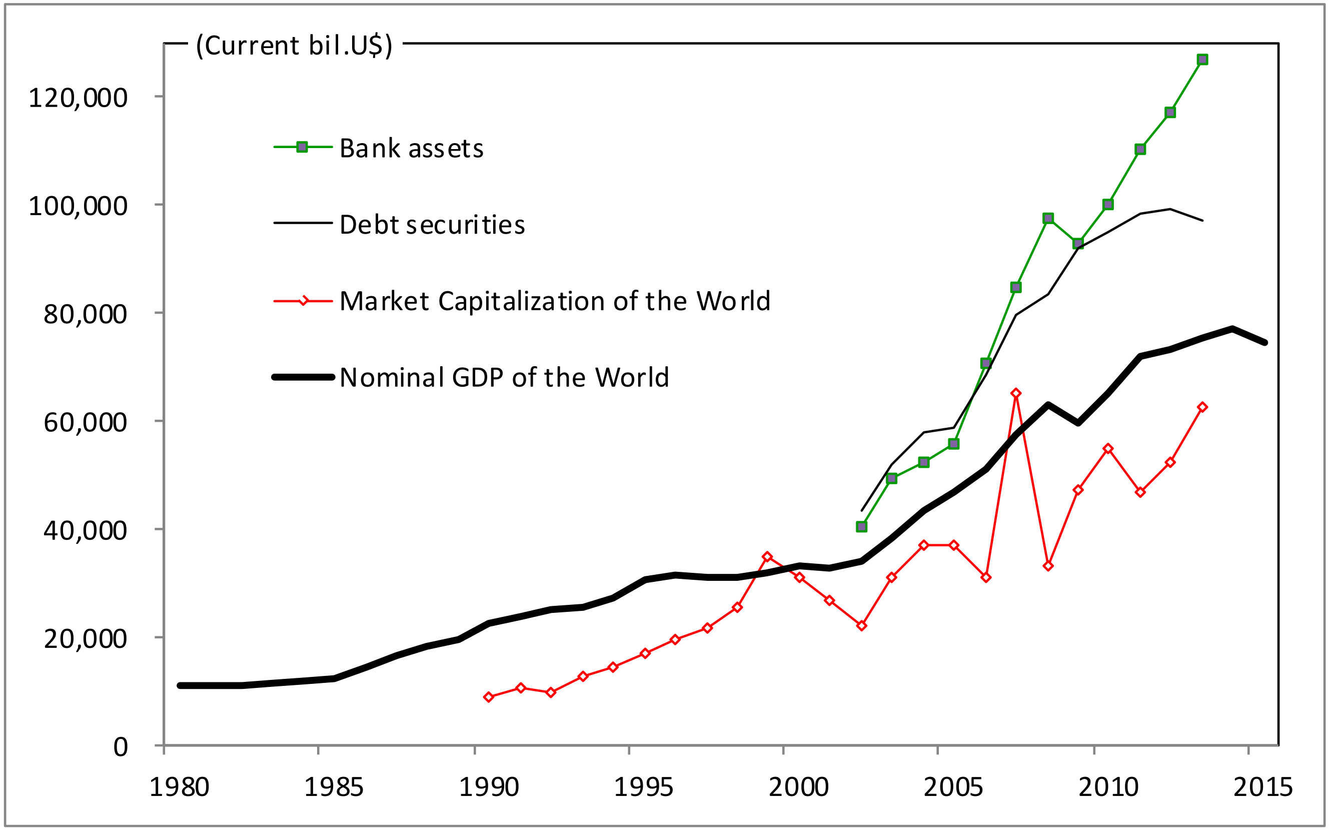
1. World of Finance

(1) Whole Figure of the World Finance

Although there are sometimes a shrinkage of equity assets due to price collapses, financial assets in general tend to grow faster than real economy.

Financial assets and Real economies
金融資産と実体経済

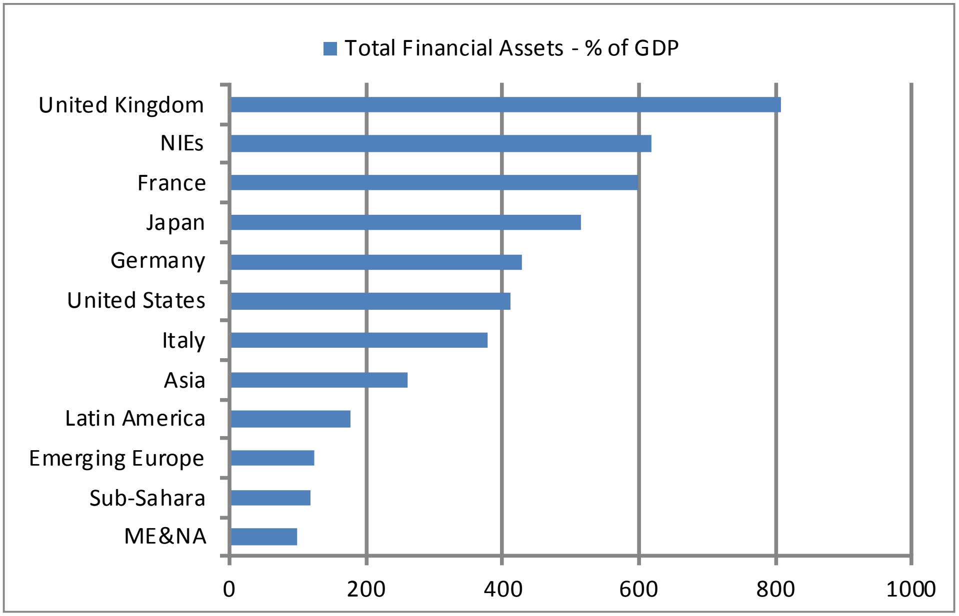


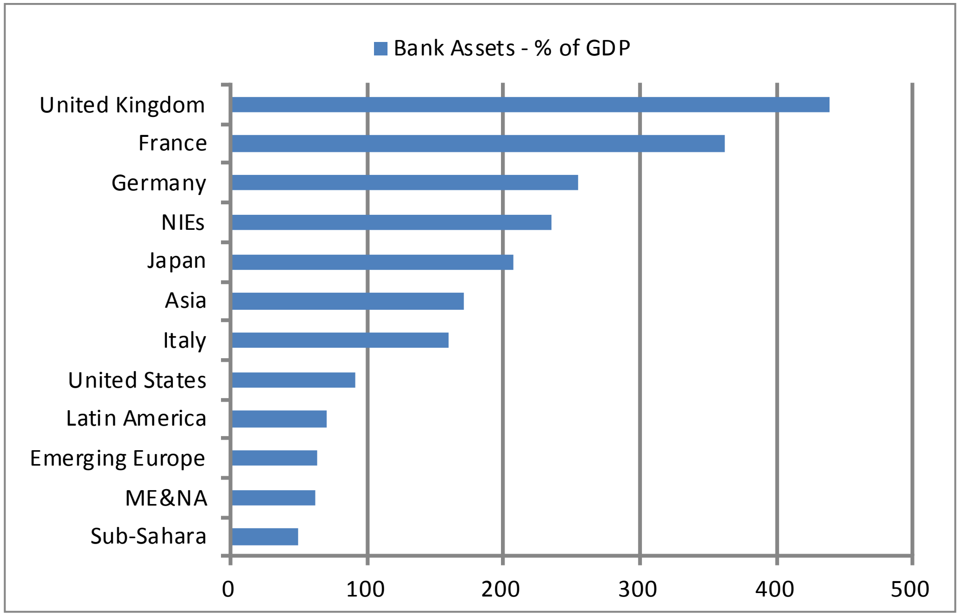
(Source) IMF, WFE

The advanced countries tend to have a larger financial assets than the emerging countries.

Among emerging countries, Asia has relatively a large financial assets.

In particular, bank assets in Asia is huge compared to other emerging regions. In other words, Asia has a bank dominant financial system.





(Source) IMF, Global Financial Stability Report, April 2014

(2) Different Financial Structure in Different Countries

Finance has typically three channels: (a)Bank loans, (b)Bonds and (c)Equities

The proportion of the three varies by country.

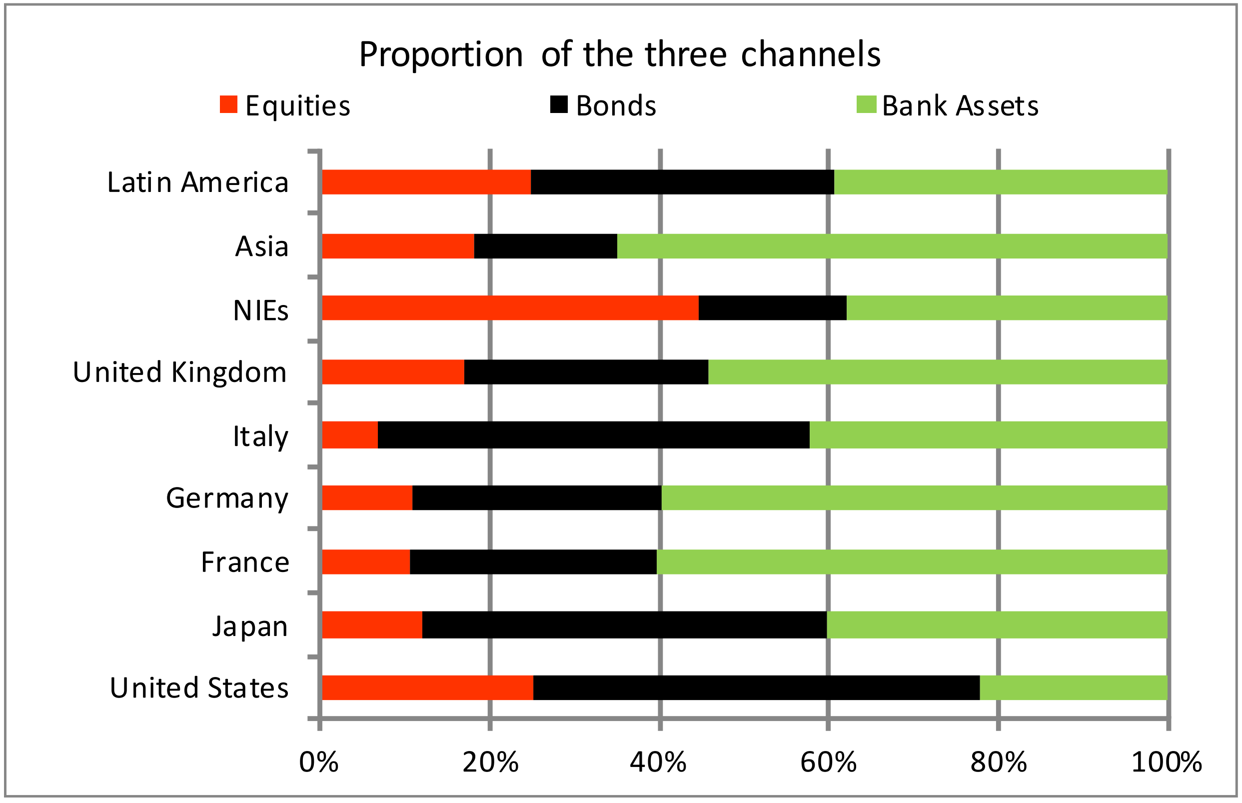
US has comparatively small bank assets. It reflects that they have both the biggest government bond market and biggest corporate bond market in the world.

Japan and Italy has a large bond markets, too. But it is mainly due to its large public debt finance.

NIEs has a large equity market and it is mainly due to the highly developed equities markets in Hong Kong and Singapore.

Some think that bond finance is a more progressive form of debt finance than bank loans. But it is not exactly a matter of progress but a matter how credit information is disclosed by debtors and collected and processed by creditors.

World of Finance



(Source) IMF, Global Financial Stability Report, April 2014

Example of Flow of Funds

The most important statistics for an analysis of financial status of a country is Flow of Funds.

Here present examples of Japan and the US.

The statistics shows:

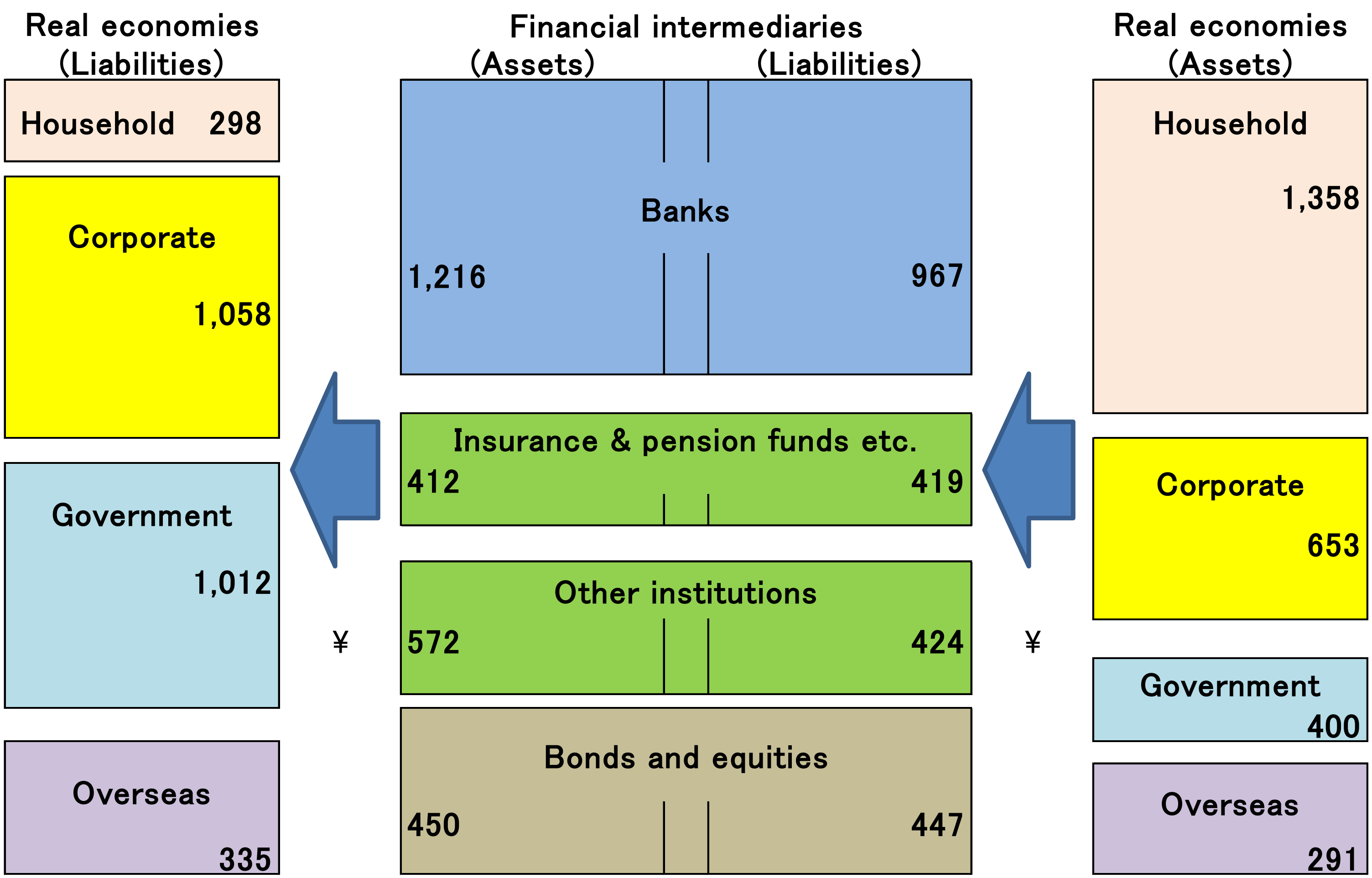
(a)which sector of the real economy has financial assets

(b)through which financial intermediary the assets are transferred

(c)which sector of the real economy receives the money.

Flows of Funds of Japan (Outstanding base)

Flow of Funds, Japan (tril.yen, end of 2010)

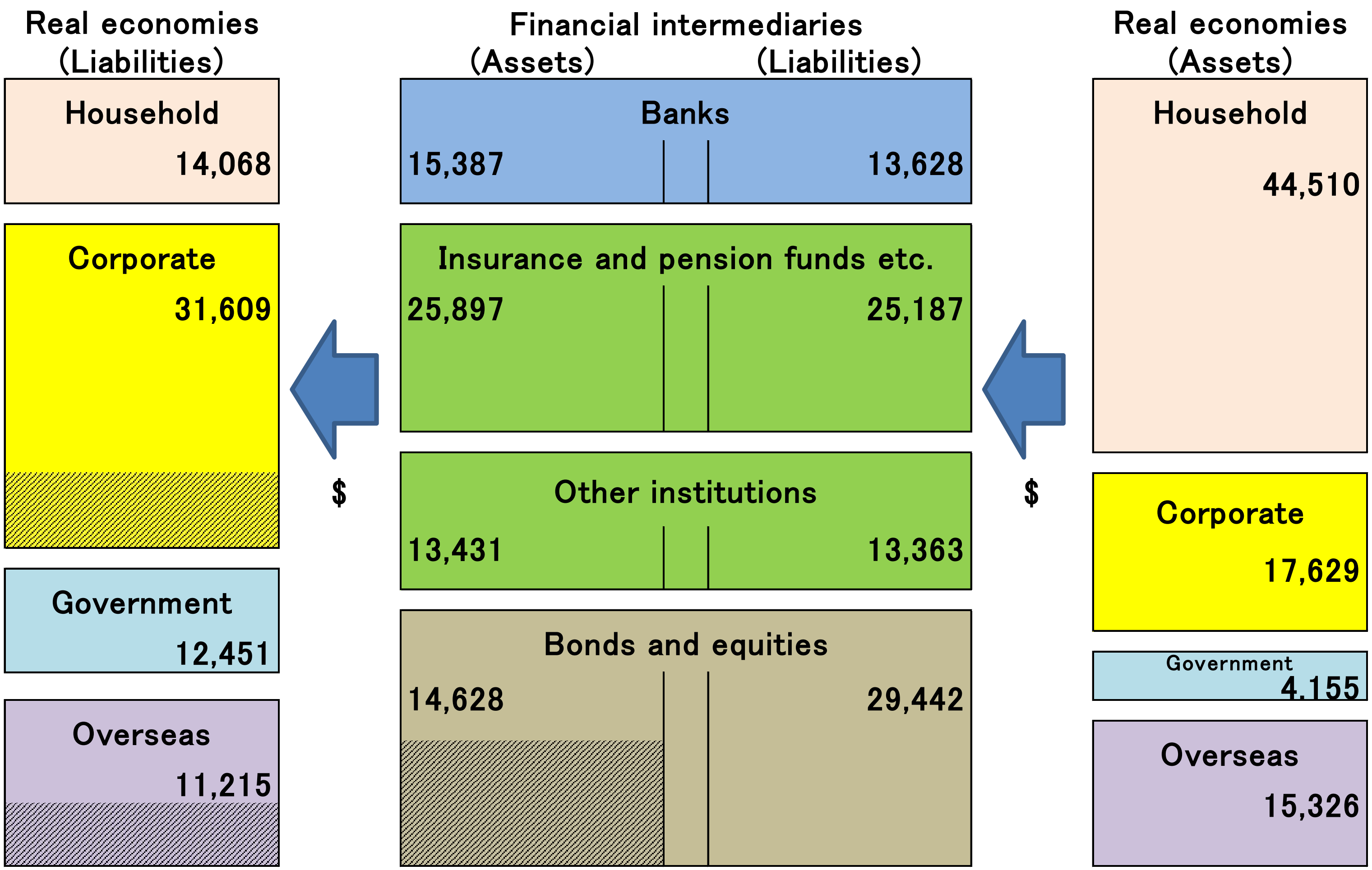


[Japan]

➢Outstanding feature is the dominance of banks in the financial intermediaries.

Flows of Funds of the US (Outstanding base)

Flow of Funds, US (bil.dollars, end of 2009)



[US]

➢Banks' role is small while institutional investors and securities (papers) play a bigger role in financial intermediation.

(3) Bank Finance vs. Bond Finance

How bank finance works

A) Banks collect deposits as a source of lending. If they can't collect enough deposit, they call money in interbank money markets.

B) Banks lend money to a borrower and traditionally they keep the claim until its maturity.

C) Regarding credit enhancement, things work as the following i–ii–iii:

i. How the credit information of borrowers is collected and checked?

ii. If the credibility is not sufficient, how will banks try to enhance it?

iii. What would happen, if a borrower fails to pay?

In case of Bank Finance

i. How the credit information of borrowers is collected and checked?

Bank officers do it before lending and during lending until maturity date comes. It is called MONITORING. Usually a bank handles various financial transactions with borrowers so that it can notice how the borrower's economic activities are going on a daily basis.

ii. If the credibility is not sufficient, how will banks try to enhance it?

When the credit status of the borrower gets worse, bank requires additional cash or other collaterals. Bank is practically in a position to watch borrowers by monitoring each transaction of borrowers' deposits with them and can freeze in necessity the borrowers' deposits or force them to deposit more cash with them. Banks are absolutely powerful in monitoring the borrowers.

iii. What would happen, if a borrower fails to pay?

Bank runs to the borrower to dispose any remaining assets of the borrower to recover the loss. If the bank fail to make a full recover, they dispose it on their own capital.

If the loss seems to become bigger than their capital, the government announces that the depositors are protected by the Deposit Insurance System and starts preparing capital injection by using public funds.

If the government fails to do it in time, the depositors run to the bank to withdraw their deposit. It is called BANK RUN.

Also if the government is too poor to do it, the IMF or richer governments of a supranational union they belong (e.g. EU) will lend the government money for capital injection.

In case of Bond Finance

How bond finance works

A) While a bank is an institute where many people work for bank finance, a bond is a paper on which a contract is written. Under that contract, investors and issuers are agreed on a money transaction.

B) A company, if their good credibility is well-known, can borrow larger amount of money by issuing bond at a lower cost than the case of bank loans.

C) Higher yield and higher liquidity are attractive points for investors compared to finances channeled by banks.

D) Regarding credit enhancement, things work as the following i – ii – iii:

i. How the credit information of borrowers is collected and checked?
ii. How the credit of borrowers can be enhanced?
iii. What would happen, if a borrower fails to pay?

i. How the credit information of borrowers is collected and checked?

A securities house, who originate a bond finance, ask a bond issuer to prepare a "prospectus of issuance", that explains the credibility of the issuer so that investors can know necessary credit information before investment.

It is investors that are responsible for credit analysis. They are required to check the prospectus or any other public information of the issuers.

ii. How the credit of issuers can be enhanced?

It is possible to set up a collateral in bond as often seen in the case of asset backed bonds. But once a bond is launched, it is very difficult to require additional collateral.

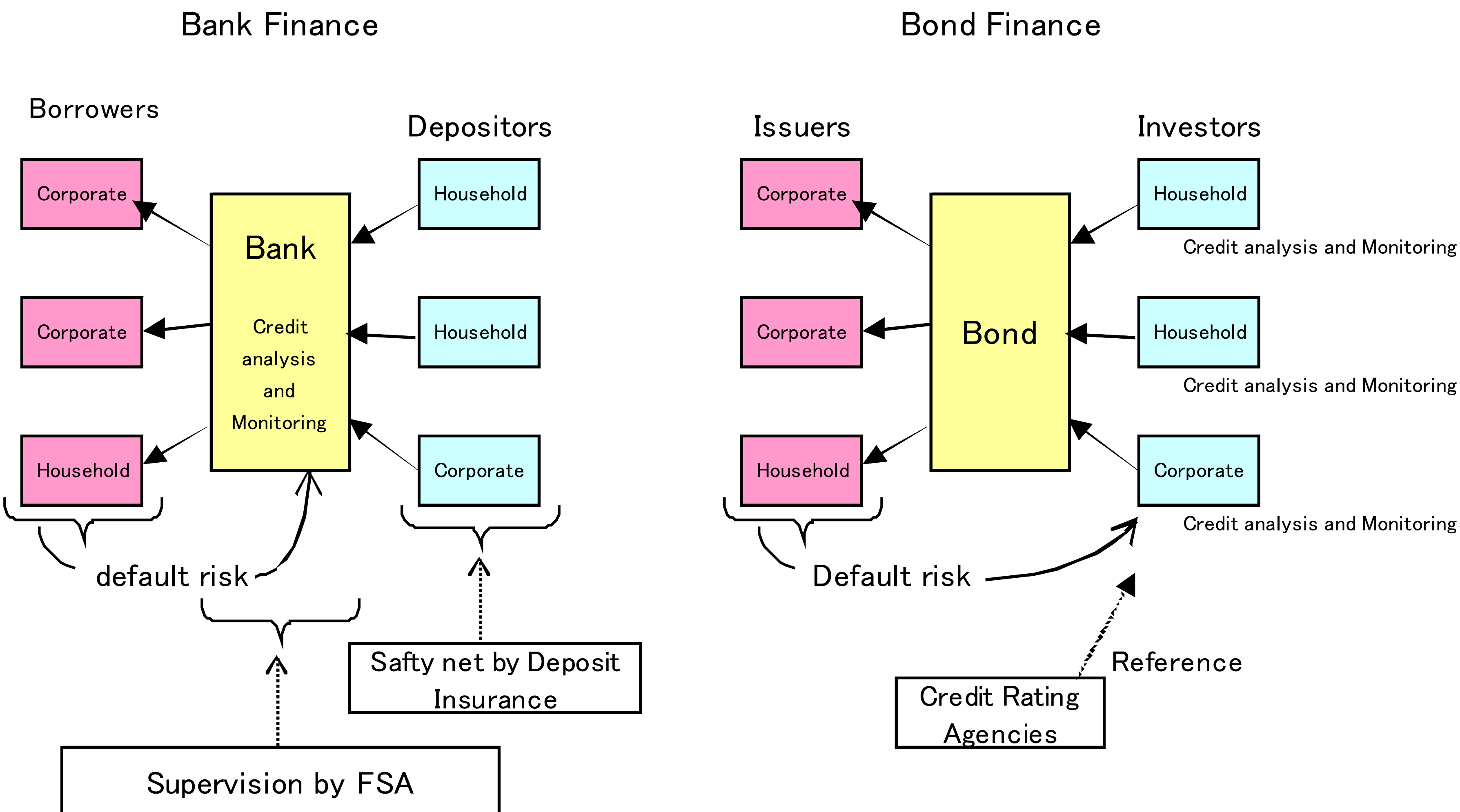
Although investors are responsible to watch the credit of the issuer, investors can practically do very little to monitor the issuer.

iii.　What would happen, if an issuer defaults?

Default is a crucial damage for the issuer. They will be shut out of capital markets for new funding for a long time after that.

But as for the existing bonds, investors suffer, too.. There is no practical action that investors can take to preserve the value of their investment when the issuer defaults.

Bank finance and bond finance has a similar structure in a good time. But once debtors default, fundamental differences emerge on the surface.



(4) Government Intervention and Finance

Finance should be left to the private sector in market principles in most of the time. But governmental support sometimes become justified or even indispensable. What is the case?

Example

Quick Underwriting Measure in Korea(2000)

Quick Underwriting Measure in Korea(2000)

When bond-redemption risks began to spread in bond markets in 2001, Korea Development Bank (KDB) acted very quickly and effectively to maintain confidence in the markets on the instructions of the South Korean government.

The policy was called "Quick Underwriting Measure". KDB played the core role as the underwriter to calm spreading concerns in bond markets.

Corporate bonds subject to the "Quick Underwriting Measure" had to meet the condition that 20 percent of those becoming due must be repaid by the issuers themselves, with the remaining 80 percent to be renewed and underwritten by KDB.

The corporate bonds of major South Korean companies were successfully renewed using this funding scheme, which helped avoid panic in the bond markets.

It is important to note that development banks' efforts to recover market confidence always raise the issue of moral hazards for both creditors and debtors, who easily come to believe that the financial authorities will always rescue them in an emergency.

Discouraging such a moral hazard requires the establishment of transparent criteria for the selection of businesses to be revitalized.

KDB set the following conditions on companies eligible for the "Quick Underwriting Measure", to discourage moral hazards.

- Companies must be facing temporary liquidity risks and problems caused by repayments of debentures with concentrated maturities, although they can refund 20 percent of debentures at maturity.
- Companies conducting a workout or under legal control are excluded, as are good-credit-standing companies that can renew their bonds by themselves.
- Companies whose reconstruction plans are deemed effective are included.
- The "Quick Underwriting Measure" underwrites renewed corporate debentures with a maturity of one year.

2. World of Bond

(1) Key Words and Key Actors

Key Words

Words	Meaning
Coupon	Interest rate is called coupon in bonds. It is usually fixed interest rate. Coupon is usually paid semiannually.
Principle	Nominal amount of a bond.
Maturity	Due date when the principle amount and final coupon is paid.
Floating rate bonds	Also called Floating Rate Note (FRN). This is a bond whose interest rate is variable.
Discount or premium	Bonds are priced out of a hundred in full value. If the price is below 100, say 98.5, it is called “discount” and if the price is above 100, say 102.5, it is called “premium”. If the price is 100, it is called “per value”.
Yield to maturity (YTM)	It is an yield or a return for investors in case they buy it now and hold it until maturity. Yield to maturity depends on the size of the coupon and purchased value. If the remaining maturity is one year, coupon is 5% and purchased price is 98.5, YTM is ((100+5)/98.5-1)=6.59%
Credit rating (or Rating)	Rating that describe the credibility of bond issuers. Rating agencies provide this service. Typically AAA is the highest rating and then becomes AA, A, BBB, BB, B, CCC, …as credit status

Key Actors

Actors	Meaning
Issuers	Those who issue bonds. Debtors or borrowers in bank finance
Investors	Those who invest bonds. Depositors in bank finance. The most important difference between investors and depositors is that investors are in charge of credit judgment and it is them who take a credit risk when debtors default, while depositors are not in charge of credit judgment and they are partly protected by a deposit insurance when debtors default.
Lead manager	The financial institution who originate a bond issuance for a company. In case of bank finance, it will be a loan officer. If the lead manager and underwriters can't place all of the issued amount in markets, the lead manager is responsible to invest all remaining bonds.
Underwriters	They will purchase directly from the lead manager newly issued bonds at launching and then they sell the bonds to investors. If they can't sell all, they hold the remaining bonds or sell back to the lead manager.
Custodian	They provide back office service such as cash payment, transferring bond holders, coupon payment, etc.
Rating agencies	They provide credit ratings to each bond or bond issuer. Ratings are credit information which most of investors rely on when they invest. But what they provide is a reference of the investment and not a judgment of investment. They were blamed of their wrong

2. World of Bond

(2) How Bond Finance Starts

Start of bond finance is called LAUNCH. Different from bank loans, each launch is evaluated as success or failure by general market participants.

Success means well received by investors, meaning all issuing amount is quickly purchased.

Success depends on two factors.

One is an appropriate pricing of credit which appears on the yield spread of the bonds against benchmark bond, usually long term central government bond of the country denominated in the same currency.

The other is a general sentiments of bond markets of the country. Although the pricing of the bond is appropriate, investors’ appetite will subdue if the market sentiment is deteriorated due to e.g. a surprise announcement of monetary tightening by central bankers.

What is a good pricing?

Appropriate pricing of bond is crucial for successful launching.

What issuers care is the cost of issuance. They are happier if the cost is lower. But too cheap funding cost will risk at bad perception of bond.

What investors care is the yield of bond. They are happier if the yield is higher.