A spare tire for capital markets: Fostering corporate bond markets in Asia; Monetary and Economic Department; Bank for International Settlements

The present report provides a brief update of the local currency bond markets in Asia, also elaborating on specific issues with regard to the corporate bond markets. These issues include the narrow range of credit quality, the limited role of infrastructure bonds, the lack of liquidity in secondary markets and the relative underdevelopment of hedging instruments and repo markets.

The major initiatives in the Asian region to enhance the local currency and bond markets have been the Asian Bond Fund 2 (ABF2), and the Asian Bond Market Initiative (ABMI) respectively. In 2005, the finance ministers of the governments of the (ASEAN + 3) nations met in Madrid and launched a roadmap for developing local currency bond markets. The roadmap focused on four areas: promoting issuance of local-currency bonds, fostering demand for these bonds, improving the regulatory framework, and enhancing market infrastructure. While the ABF2 initiative focused clearly on just government and quasigovernment bonds, the ABMI roadmap of 2005 did not distinguish between government bonds and corporate bonds. But given the much smaller size of corporate versus government bond markets at the time, the ASEAN+3 focused largely on issues related to government bonds. The closest the ASEAN+3 governments have come to directly promoting corporate bonds has been to encourage issuance by state-owned firms, including financial institutions, and to set up the Credit Guarantee and Investment Facility (CGIF). For its part, the CGIF started operations in 2012, with authorized capital of USD700 million and with the ADB as trustee. By 2014, the facility had issued guarantees amounting to a total of USD740 million. While the guarantees make the corporate bonds more like government bonds in terms of credit quality, they do not necessarily foster the assessment and pricing of credit risk by the market.

The size of the corporate bond markets has significantly increased since 2005, as issuance of local currency corporate bonds has surged in the eight ABF2 economies. In absolute dollar amounts, Chinese and South Korean markets are the largest. One aspect in which corporate bond markets have not developed greatly in emerging Asia is in the range of credit quality available to investors. A wider range of investment choices would both enhance market depth, in addition to providing an alternative to bank financing for less than pristine credits. For the most part, issuers and investors don't take full advantage of the wider range of credit risks offered by local currency ratings. While an argument can be made that lower credit quality issuers are well serviced by a well-developed banking sector in many jurisdictions of the Asia-Pacific, having readily available alternative sources of financing should lower borrowing costs and increase investment opportunities.

One member jurisdiction has noted that streamlining documentary requirements could encourage more corporate bond issuance, even from companies with lower credit ratings. Given the prominent role of institutional investors in Asia, lowering or removing the credit rating floors of institutional investors could also help. Ratings below common regulatory cut-off levels such as investment-grade can be useful for financial market development.
The infrastructure needs of the ABF2 economies are vast, and various observers have suggested that a well-functioning corporate bond market would help finance those needs. These bonds offer certain advantages over bank financing. They can offer maturities that match the time profile of a project's cash flows, something that would be difficult to do with bank financing. They would also tap a new investor base. In a less developed corporate bond market, the issuance of infrastructure bonds can pose formidable challenges. If these challenges can be surmounted, however, such bonds can go a long way in furthering the development of the corporate bond market. Infrastructure bonds can help diversify the market, particularly by widening the range of credit quality that the market gets to price and to trade.

Liquidity in secondary markets is an equally important aspect of bond market development. Liquidity affects the cost and timeliness with which corporations can raise funds, as well as the degree to which market prices reflect the credit risk across securities in a stable and consistent fashion. Bid-ask spreads are a commonly used metric of bond market liquidity. Although these spreads were not reported in the 2011 report, recent estimates by a private bank of the range for bid-ask spreads for corporate bonds in the region suggest that not only do they remain well above those of government bonds in the corresponding jurisdiction, but for most jurisdictions, they have not declined since the time of a BIS study of 10 years ago.

Jurisdictions in Asia may have their own rationales for encouraging transparency in trading. Particularly in Asia, the market for corporate bonds tends to be dominated by large institutional investors, who trade large ticket sizes infrequently. There may be a greater role for government to ensure a level playing field for small and/or non-local investors and trading service providers. At the same time, the markets are generally smaller and more heterogeneous than those in the US and Europe; transparency may gain in importance in encouraging less informed investors to participate given the different languages and legal frameworks. Thus, it is perhaps not surprising that Asian jurisdictions are also making efforts to increase post-trade transparency. In most ABF2 countries reporting is in fact now mandatory for all OTC trades. The exceptions are Hong Kong and Singapore. The timing for the mandatory reporting of trades differs across jurisdictions.

The transparency regimes in Asia are fragmented. While each of the ABF2 markets mandates a form of post-trade transparency, currently, the data for the ABF markets where provided are neither standardized nor accessible on a single access platform. Consolidated information on corporate bonds is not available in the executive's meeting of East Asia Pacific Central Banks (EMEAP) jurisdictions.

Markets to hedge foreign exchange risk support underlying local currency bond markets in several respects. However, differential liquidity likely reflects impediments of the use of FX derivatives markets in Asia and for Asian currencies. Non-resident investors continue to have free access to onshore FX hedging instruments in Hong Kong and for the respective spot instruments in Singapore and Thailand. In Indonesia, Korea and Malaysia, foreign investors can use FX hedging tools only if they provide documentary proof of underlying exposure. In the Philippines, prior approval is required for FX swaps involving an offshore counterparty. One jurisdiction where significant progress can be reported is in China, where non-residents now have access to the spot market under the QFII scheme subject to approved
quotas; and central banks, sovereign wealth funds and others have access under the China interbank bond market FX mechanism.

The development of hedging markets and local currency bond markets are naturally linked. FX swaps or derivatives markets which allow foreign borrowers to convert currencies can be a boon to local currency issuance. Likewise, the increased ability to invest across markets and hedge these investments facilitated through further liberalization of the capital account among other measures has been shown to increase issuance in local currency jurisdictions. Competition from the offshore markets can improve domestic policies and market efficiency, not least by reducing the power of domestic incumbents that benefit from domestic regulations.

It is now widely recognized that the development of repo markets is important for the development and liquidity of local currency bond markets more generally. According to a 2001 report on the EMEAP, repo markets at the time were lagging well beyond unsecured money markets in the region, both in terms of the variety of collateral provided and the parties to the transactions. The lack of a legal apparatus was emphasized: financial institutions were imposing credit limits on repo transactions because existing legal frameworks at the time, in many jurisdictions failed to ensure that lender could take possession of collateral. Many authorities were not yet utilizing the Global Master Repurchase Agreement (GMRA) which stipulates safeguards to credit rights; neither had they initiated a market wide standard local annex to GMRA which would encourage its use among private parties. The report also emphasized the lack of suitable collateral, as well as tripartite repo being underutilized as solution to the problems faced by the repo markets. By 2014 though, significant progress had been documented in a number of jurisdictions.

The 2011 report also identified a number of specific country impediments. For instance, according to accounting practice in Indonesia, repos are treated as a secured loan whereby collateral remains on the balance sheet, meaning that a true sale, or transfer of ownership, does not occur at the time of the repo transaction. This contributes to uncertainty about the treatment of collateral in bankruptcy. Similarly, in the Philippines, there are restrictions on the use of collateral which diminishes its characteristics as a “true repo”. Tri-party repo arrangements were still not available in five of the EMEAP jurisdictions, and GMRA’s were still not available for use in China, Indonesia and the Philippines.

Overall though, industry sources are fairly consistent in indicating that term repos are becoming more utilized as a result of regulatory pressures to increase the duration of their liabilities. That result could not be confirmed in the EMEAP report however, as the tenor composition of repos was not available for four jurisdictions, and not reported for others. Another stylized fact that has emerged in interviews with private sector market participants is that synthetic repos have increasingly emerged as an alternative to conventional repo at longer maturities.

In conclusion, the authors suggest that to maximize the support from repo markets, a survey could be conducted to close existing data gaps and identify optimal policy actions.

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